DOING AWAY WITH BUDGETS

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Introduction

Budgeting has been the "number crunching" preoccupation of the finance function for a long long time. Depending upon the organisation in which the finance function operated, this task has established itself in cycles, *sometimes* linked to the business planning process. While at the extreme some organisations carry it out on a monthly basis, others would do so on a quarterly basis while in a majority of organisations the half yearly and annual budgeting cycles is almost mandatory. It would almost be unthinkable for the traditional accountant not to be caught up in the budgeting process and the designation Budget Accountant or Manager Budgets is yet quite common in many organisations. It is most likely that organisations' infatuation with budgets is driven by the underlying need to satisfy various stakeholders that the organisation is on track to achieve its stated outcomes – albeit in financial terms. Many public companies are required to publish quarterly projections of performance which keep shareholders informed and therefore influence financial markets. Lending institutions also demand for such projections in order to ensure that their monies are safe. It would surprise many an accountant to know that there is a growing trend among leading global organisations to do away with traditional budgets – and they are so much better off for the experience.

The word "budget" can have many connotations. As a noun it refers to a summary of probable financial outlays and incomes over a specified period as well as the total amount of money allocated for a specific purpose during a specified period. In the context of the verb, it means to plan the expenditure of money and other resources. While these are all acceptable in the context of operating an organisation, management has in most instances used budgets above and beyond these definitions. Budgets have increasingly been used as a management performance measure as well as a cost reduction tool and it is in this context that it is being questioned as to the value derived against the effort required. In fact in the current business climate of rapid change budgets often are constraints to success. The role of the finance function too is changing and with increasing value added being demanded from all areas of an organisation the long term sustainability of budgeting as a prime focus of the finance function is being challenged.

Should organisations be moving away from budgets?

Budgeting, by its very definition of providing “probable” financial outlays and incomes over a specified period, is very much dependant upon assumptions about a future period which is commonly referred to as a planning horizon. The pace of business and commerce has been rapidly changing with the planning horizon becoming shorter and shorter. Even Management is now taking a short-term view. Today the average American CEO is not looking beyond a three-year tenure. This management time warp is resulting in organisations having to react ever so quickly to changing interactive external and internal circumstances in order to exploit opportunities and minimise the impact of threats. Even mere survival is a challenge as has been proven by the demise of many of the dot coms. Thus, to establish budgets in the traditional sense based on a set of fixed medium to long term assumptions is very inappropriate. Besides it would seem to be a wasted effort with the scarce resources that many organisations have today, capable of being better utilised in a more value adding pursuit. In this context it is difficult to argue a case for organisations continuing to spend the inordinate amount of time and effort that goes into the budgeting process. Collectively business and commerce must consume huge volumes of time, effort and consequently costs on a traditional formality that adds little value. It is therefore time to consider if organisations should be moving away from budgets.

How much value does the entire budgeting process add?

Taking the line of thought described above then begs the question: How much value does the entire budgeting process add? To answer this question appropriately it is interesting to review the budgeting process common to most organisations. As stated in the opening sentence of this article the preparation of budgets has always been relegated to the finance function in the context of its supporting role to the core business areas of the organisation. Thus, typically, a management accountant would be provided with some basic information in respect of sales, cost of sales, overheads and maybe some new product development or capital investment decisions and requested to come up with an operating budget. The information would be provided by a departmental manager, product manager or a regional manager who would have participated in some form of business planning exercise at a senior level within the organisation. Often diluted information is passed down and that which has been interpreted by the manager concerned. The management accountant is then left to crunch the numbers, having of course obtained some detail from operational management, the sales department and the purchasing department. This process occurs across many departments or regions until the finance function can come up with a consolidated budget for the organisation. This is more realistically an expenditure forecast and, considering the rigour that would have gone into its preparation, using such figures as a performance measure is hardly prudent.

In other organisations the budgeting process starts at the lowest level with many individuals from every department getting involved in producing its operational budget with support from the management accountant and again the consolidated organisational budget is compiled by the finance function. Experience shows that this method has inherent flaws. The widespread involvement of so many individuals obviously means that uniform criteria have not been applied across the process.

In both cases a significant investment in time and effort has gone in, but what value has been added? In most organisations what has been achieved is merely a forecast estimate of revenues and expenditures. It is also common practice for the corporate finance group or head office to ultimately reduce the figure by an arbitrary percentage. It is very probable that the outcome hardly has any bearing to the organisation's business plan or strategy. Further, it is the consolidation of estimates arrived at in separate silos with little or no appreciation for common organisational outcomes. What is certain is that management will use this probable estimate – referred to as a budget – as a performance management tool or as a basis for cost cutting. Over the years operational managers have realised this underlying management philosophy with regards to budgets and have learned to play the game. This being the case how much value has the budgeting process added?

Are there better management tools replacing traditional budgets?

If command and control has been the major purpose of an organisation's budgeting process – as it likely is the case in most organisations – then much time and cost has been expended with little value to show for it. We are all too familiar with the term "budgetary control" and getting into denial mode will not help. In fact the command and control philosophy itself, in the current business climate, must be questioned. It is proving to be an impediment to progress in the fast changing environment. This being the case there are better and more reliable management tools available that will not be influenced by managers attempting to circumvent the system, nor acting as a constraint but yet empowering managers to deliver overall organisational expectations. The Balanced Scorecard is one such tool and so is Benchmarking.

While traditional budgets essentially take into consideration only financial indicators of an organisation's performance, the Balanced Scorecard approach looks across a number of areas such as customers, organisational processes, learning and growth as well as finance. These facets are much more indicative of the overall performance of an organisation and challenges Management to consider above and beyond the bottom line. Some may argue that even this being the case budgets are still relevant. Not so, indicative rolling forecasts or dynamic budgeting maybe but certainly not budgets as is currently used. As will be seen in the next section budgets tend to stifle progress.

Benchmarking is yet another tool that provides organisations with an effective means of measuring its performance in comparison to external organisations. Thus the shortcoming of traditional budgets is obvious. It is essentially internally focussed and that too only considering mere financial indicators. It is even not stretched to the extent of normalising across various internal departments as each department of an organistaion would most likely compile its budget in isolation and these figures are merely consolidated in order to provide an organisational total. The Balanced Scorecard however looks across the entire organisation in respect of the multiple indicators and Benchmarking compares performance across organisations and it can also be used to compare across various departments within the same organisation.

Organisations have paid only sparse attention to other techniques such as rolling forecasts, or dynamic budgeting, that offer the flexibility of mirroring in financial terms the reaction to strategy changes or investment decisions or changes in the environment Thus it could be argued that these new management tools add more value to organisations than the traditional budgeting process.

What are the disadvantages and business constraints imposed by budgets?

The information age has certainly thrown a number of challenges to the present day managers. The business issues that drive organisational performance today are indeed different to those of even a decade ago and certainly very different to those of the industrial age at which stage the concepts of traditional budgeting were established. Robin Fraser, Programme Director of the CAM-I Beyond Budgeting Round Table, refers to the shift in business models from “make-and-sell” to “sense-and-respond”. While the former was relevant to the industrial age the latter is typical of the information age. Thus in the current commercial climate the key issues for success are; being able to respond fast, having the best people on board, introducing new business concepts, reducing costs, having the right customers and satisfying shareholders. Budgets and the command and control mentality stemming from the approach certainly do not support these issues. Let us consider each of them in the context of the traditional budgetary control framework where organisational budgets are usually established well in advance of the time period in question.

Typically, compilation of an annual budget commences three to six months prior to the commencement of the budget period and therefore the latter period of the budget's life cycle is up to eighteen months from the time that assumptions in respect of performance were made. Eighteen months is a long period in the context of a business in this day and age of change. Consequently the budget – in the context of a performance management tool - has positioned the organisation in a straightjacket preventing it from responding to change fast. In respect of attracting the best people to the organisation too a budget mentality acts as a deterrent. Today good managers want the flexibility and empowerment to act independently as well as in response to a changing business environment and surveys have demonstrated that this aspect is important in attracting the best employees. It is plainly obvious that an organisation whose philosophy is very much budget focussed will not attract the quality employees and managers it needs. This leads to the related issue of the introduction of new business concepts and ideas. A strict budget driven organisation undoubtedly stifles any new business concepts simply because it shifts the original points of reference and changes the original assumptions upon which the budgets were formulated. It is patently obvious that one or the other has to give way. They simply cannot co-exist. Thus a budget driven business organisation has lost its competitive edge because it cannot offer challenges to innovative staff and also suffers from not being able to move ahead.

Getting on to cost reduction. It is mistakenly construed that budgets control costs. With the hindsight of experience I can say that there is nothing further from the truth. This is true for two reasons. Firstly, managers whose performances are linked to budgets have learnt to "play the game". No degree of policing the budget formulation process can ensure that there is no fat included. Thus, managers are not stretched in any way to really explore new business concepts in order to reduce costs. In most instances managers actually spend up to the budget limit just in case they are seen to be adopting a conservative approach. When pushed to demonstrate improvements they can easily do so. Year on year budget reductions only have a very ineffective impact on organisations and only serve to stretch the improvement horizon. Managers who have reached the point of minimum cost often tend to stint on scope, to the detriment of the organisation, in order to demonstrate cost savings. This is because they have not been required to explore innovation and continuous improvement due to the budget culture in the organisation.

Managers who are required to operate without the budget as a reference point invariably will only spend the minimum and explore innovative means of process improvement if other performance management tools such as the Balanced Scorecard or Benchmarking were adopted. This is the similar argument when considering the plight of the shareholder in the context of the budget control philosophy. Instead of increasing the organisation's value to the shareholder by intrinsically improving the organisation and hence improving profits, cost reduction by scope reduction is achieved. Customers are never considered in the budget formulation process most likely as only their cost to the organisation is being considered. The benefits of retaining the right type of customer and consequently the significant increased costs of attracting new customers in place of those lost is never considered in a budgetary control environment. Thus the constraints to the information age business because of the burden of budgets is clearly demonstrated.

Is the changing face of the finance function impacting on the way organisations think of budgets?

The changing focus of the finance function is also impacting on the way that organisations are looking at budgets. It must be appreciated that the finance function is moving away from the traditional number crunching tasks that were the mainstay of the area. With the trend towards the use of Shared Service Centres, both within the organisation and as outsourced services, the finance function is moving towards more value adding services at a lower cost. It is in fact shedding the resources that carry out these mundane tasks that were once packaged as financial services. The huge costs associated with compiling traditional departmental budgets which ultimately roll up into a consolidated organisational budget is seen as adding little value from the finance function and more so offering little challenge to accountants. The finance function is moving more towards providing a strategic contribution to the shareholders. It is thus now turning its attention to involvement with Balanced Scorecards, Benchmarking and Strategic Management Accounting – areas which have potential to add significantly to organisational performance and once again demonstrate the value adding capability of the finance function.

If budgets are deemed necessary, then how should they be compiled in this age of technology and knowledge management?

Much as the downside of traditional budgeting is demonstrated there will be organisations that will not be able to shift its mindset and its infatuation with budgets.

While most of the more progressive private sector organisations will eventually move away from the command and control climate offered by budgetary control, government departments and government trading enterprises will find it more difficult because of the restrictions and demands of Treasury. However, all those organisations that will continue to be burdened with this seemingly inappropriate and non value adding budgeting process must explore new, better and more cost effective methods of meeting the requirement. Fortunately the very same factors that have made budgets superfluous ie. technology advancements and the knowledge age have also offered the remedy for achieving an effective budgeting process. Enterprise Resource Planning (ERP) software, Customer Relationship Management (CRM) software, knowledge systems, ecommerce, interactive software and the like can contribute towards significantly reducing the cycle time for budget preparation. There is definitely the opportunity for dynamic budgeting being built into the integrated systems. Online Analytical Processing (OLAP) tools incorporated in many of the leading software packages such as PeopleSoft and SAP offer the facility of integrated budgeting. In fact organisational knowledge systems coupled with external databases and CRM can even take much of the arbitrary assumptions out of the budgeting process. Of course if budgetary control is yet seen as a performance management mechanism those managers whose performance is measured against such budgets will need to be much more effective given that their input to the assumptions have been removed and they are being refereed by an independent and they are no longer playing a game they once controlled. What is still evident, however much the budgeting process is refined, is that the ultimate outcome is still only a forecast based at some point in the past. It will still be a constraint upon managers to sense and respond. The question remains – how much value does the budgeting process add?

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References:

- Robin Fraser ; Jeremy Hope, "Figures of hate, ", Financial Management February 2001
- Robin Fraser and Jeremy Hope have done much work on the topic of budgeting in organisations and Robin's CIMA Master Course on Beyond Budgeting is popular globally.
- CAM-I The Consortium for Advanced Manufacturing – International has set up a Beyond Budgeting Round Table (BBRT) in Australia & New Zealand. The Program Directors can be contacted on (02)9241 3516