

Do We need Budgeting?

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Abstract - Budgeting is considered as the most dominant mechanism for management control in the contemporary organization. But, there is a growing debate over replacement of Budgeting with the new management tools for better management control. This article aims to review the reasons made by Hope and Fraser (2003) that concludes "Budgeting, as most corporations practice it, should be abolished". It is an attempt to critically analyse the arguments given by Hope and Fraser (2003) and to look at its potential implications on the organization. Although there are indications of some shifts from budgeting to a simplified version or even to alternative management tools like rolling forecasts yet a better understanding to explore the potentials challenges underlying are required. Further, it was seen that the firms do not want to abandon the existing budgeting system for management control but relatively want to improve their budgeting structures. Consequently, the organization do not abolish budgeting in its totality and it is still performing a prevalent role in management control systems. Nevertheless, there are some weaknesses in budgeting exercises which cannot be overlooked that demands reforms in traditional budgeting and future research in new management tools for better management control.

Key Words: Budgeting, Key Performance Indicators, New Performance Contract, Relative Performance Contract, New Management tools

Budgeting is considered as the most dominant mechanism for management control in the contemporary organization. But, there is a growing debate over replacement of Budgeting with the new management tools for better management control. The statement made by Hope and Fraser (2003) in the article, *Who needs Budgets* published in *Harvard Business Review*, concludes that "Budgeting, as most corporations practice it, should be abolished". This article is an attempt to critically analyse the arguments given by Hope and Fraser (2003) in light of this statement and to look at its potential implications on the organization. At the same time, the work of other researchers is examined and investigated to reach at the conclusion. It is examined that budgeting is still dominant in the management control of the organization but at the same time, there is an urgent need to reform the traditional budgeting exercises in view of new management tools to adapt in the complex market environment. Hope and Fraser (2003)

highlighted numerous flaws of budgeting such as time consuming, fixed targets, delayed market response, strategy misalignment and consequently, recommended the consideration of beyond budgeting exercises in the organization to deal with the competitive external environment. The authors noted that budgeting needs substantial amount of time for forecasting and determining the estimates pertaining to future time period and therefore, is an expensive process. Moreover, budget once set with fixed targets discourages the sharing of information and slows the reaction of the organization towards market developments, becomes out of date in the competitive environment and subsequently, gets unaligned with strategy. These arguments triggered the thoughtful debate to replace traditional budgeting and raised serious concern over the survival and continuity of budgeting principles.

The authors proposed the new performance contract to shift the prominence on relative performance contract from fixed performance contract. It was proposed that Key Performance Indicators (KPIs) to be taken as basis to set longer term goals. Further, they place an emphasis on the need to establish beyond budgeting practices or the alternative management tools such as rolling forecasts in the organizations to abridge the dominance for budgeting. The authors made significant contribution in the literature of budgeting and suggested to reform the traditional budgeting system.

To support their points, Hope and Fraser (2003) investigated the case of two companies that abolish budgeting and found drastic positive change in performance. These are Ahlsell, a Swedish wholesaler and Svenska Handelsbanken, a Swedish company with its presence in Scandinavian countries and the UK. It was reviewed that Ahlsell abolished budgeting in 1995 and began to use KPIs to set goals and rolling forecasts. This resulted in improvement in customer portfolios, profitability enhancements, lower cost transactions and enrichment of value added services. By the same token, Handelsbanken abandoned budgeting in 1970 and became one of the world's most cost- efficient banks. It was losing customers (in late 1960s) and has

transformed drastically to winning satisfied customers through a range of policies such as decentralized operations, wide span of control, target setting by regions and branches, equal share in profits to employees, resource allocation by managers and rolling forecasts. The analysis of these cases led to the conclusion that abandoning budgets in organization would help to decentralize modern information system and release its full potential.

The above discussion pointed the urgent need to do away with budgeting primarily because it is a time consuming process, unaligned with strategy, have fixed targets, no value creation to management and lacks market adaptation supported by the evidences collected from the two case studies of the companies which benefitted by abolishing budgeting exercises. It is irrefutable that the authors did a valuable analysis that provokes the academicians and researchers to think beyond budgeting yet there is a need to discover the ideas behind their arguments to rationalize the universality of this statement. It is observed that there are only a few companies that have managed to do away with budgeting exercises (Neely et al., 2003). On the other hand, there are large numbers of companies that are undertaking budgeting exercises in the organization and are not planning to abandon it in near future (Libby and Lindsay, 2010). Therefore, the demand from the proponents of modern budgeting to abolish the traditional budgeting entirely needs further investigation. This requires inquiry into domains of traditional budgeting for its so-called questionable part in time consumption, fixed targets, alignment with strategy and market reaction time for customer satisfaction. These roles are discussed in the succeeding paragraphs.

There is a lot of time spent on gathering, processing, projecting and finalizing data for budgeting. It would be time wastage when the frame of references provided in budgeting does not help the organization in taking corrective actions at the right time. In other words, the time spend would be a considerable loss in terms of man hours when the budget has incorrect estimations, wrong methods, wasteful expenditures and faulty planning. The past literature (Bunce et al., 1995, Hansen, 2011, Hope and Fraser, 2003, Neely et al., 2003) are of the viewpoint that time taken by budgeting activities does not add value to the business. On the other hand, Libby and Lindsay (2010) surveyed mid to large North American organization and found

that the time taken for budget completion and preparation by managers is significantly less. Consequently, the past literature provides mixed evidence for recognizing consumption of considerable time as one of the key problems with budgeting.

Another argument recognized in the above discussion in support of abolishment of budgets is the introduction of new performance contract in which there is a shift from fixed performance contract to relative performance contract. The authors debated to abandon fixed performance contract which strictly focus on compliance, instil fear of failure to perform, cost protection and consequently results in strategy disorientation, no value creation, centralised coordination and delayed market response. On the other hand, relative performance contract was supported to minimise cost, creation of value, dynamic coordination through Key Performance Indicators (KPIs) for flexible response to market feedback (Hope and Fraser, 2003). Proponents of this argument, for instance, Østergren and Stensaker (2011) suggested relative targets than fixed targets, KPIs to evaluate strategic long term and short term for real value creation; Hansen et al. (2003) states that the traditional budgeting fails to achieve high performance due to inadequacy of fixed targets. On the contrary, Henttu-Aho and Järvinen (2013) and Libby and Lindsay (2010) did not agree with it and considered fixed performance as a measure for performance evaluation. The fixed target budgets are related to future forecasting with adjustments in historical data after discounting for past misallocations and below normal performance. In presence of mixed evidences, there is a need to review the validity of fixed targets and to revisit its role in strategy alignment and resource allocation to evaluate the response time taken for market adaptation.

Turning to another reason that came into spotlight in support of budget abolishment is unaligned strategy. Bhimani et al. (2008) et al defined strategy as "... describing how an organisation matches its own capabilities with the opportunities in the marketplace to accomplish its overall objectives". The strategy planning aims to exploit market opportunities by planning for long run and short run courses of action that in turn provides data and facilitates formulation of Budgets. In other words, the foundation for budgets construction is to achieve the targets under strategic planning and in turn, provides feedback for better implementation of later. Consequently, the objective of

budget formulation must be to promote strategically united performance (Neely et al., 2003). It indicates that the basis of budget formulation is the accomplishment of strategically defined objective. Further, (Libby and Lindsay, 2010) did not found the budgets unaligned with strategy, but documented budgeting as a significant instrument for strategy performance. The contrasting evidences require a further analysis of the interrelationship between strategy formulation and budget construction

Going forward, argument for replacement of budgeting proposed to establish beyond budgeting practices or the alternative management tools (Hope and Fraser, 2003). The authors recognized the trade-off between traditional budgeting and the new management tools (such as rolling forecasts) and suggested replacement of budgeting to establish the later. The new management tools facilitate proactive planning whilst the traditional budgeting promotes reactive planning (Østergren and Stensaker, 2011). But at the same time, there is a need to understand and discover the features of new management tools and uncover the limited familiarity of their latent challenges. The task could be to determine the liquidity level, cost control, short term aspect and indefinite consequences (Østergren and Stensaker, 2011). It is observed that there is no study to document the real and actual implementation of Beyond Budgeting principles in firms (Østergren and Stensaker, 2011). It can be said that there is a dearth of literature to prove that the attractive aspects of beyond budgeting is not an exaggeration. The budgeting practice is changing and the emphasis on new management tools is a move towards a more flexible and simplified Budgeting procedure rather than an attempt to replace the later.

Looking at another argument by Hope and Fraser (2003) in support of abolition of budgeting is that it does not create value to business and not adaptable to market change. By the same token, (Bunce et al. (1995)) and Neely et al. (2003) recognized that budgeting fails to add value to the business and does not help the organization to adapt to market change. To elaborate, Bunce et al. (1995) states that budgeting is about supply related concerns and does not provide adjustments for customer alignment; Neely et al. (2003) points that budgeting is not able to deal with dynamic market environment. Further, Libby and Lindsay (2010) also held that the process of budgeting in firms is potentially weak for adaptation to market

change; however, they found that this reason is over generalized and firms tend to adjust their budgeting to ease this problem. It seems that this argument against budgeting raises apprehension over its implementation and questions its implication over the existence of organization in competitive environment.

The statement by Hope and Fraser (2003) with respect to budgeting raises concern over its common practice in the organization. It made a significant contribution to the current literature of Budgeting. It provided an insightful debate over flaws of budgeting and recognized the necessity to look for Beyond Budgeting aspects. It enquires for an explanation behind the rationale of time spent on the whole task of budgeting, existence of fixed performance contract, survival and role of traditional budgeting tools in value creation and evaluation of market response time for better consumer orientation. It places an emphasis on modernisation of the existing budgeting exercise which was ignored and overlooked earlier.

There is an indication of some shifts from budgeting to a simplified version or even to alternative management tools like rolling forecasts (Libby and Lindsay, 2010; Østergren and Staensaler, 2011; Henttu-Aho and Järvinen, 2013). At the same time, the encouragements towards alternative new management tools need a better understanding to explore the potentials challenges underlying beneath it. It suggests extensive research in the field of Beyond Budgeting principles and the after effects of its implementation in the organization before endorsing it to replace with budgeting. On the other hand, it can be argued that budgeting still maintains its dominant position as it is evident that there are few companies that have abandoned budgeting (Libby and Lindsay, 2010; Neely et al 2003). Further, it was seen that the firms do not want to abandon the existing budgeting system for management control but relatively want to improve their budgeting structures (Henttu-Aho and Järvinen, 2013; Libby and Lindsay, 2010). It is evident that budgeting is not abolished in the organization in its totality (Henttu-Aho and Järvinen, 2013) and is still performing a prevalent role in management control systems. Nevertheless, there are some weaknesses in budgeting exercises which cannot be overlooked that demands reforms in traditional budgeting and future research in new management tools for better management control.

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