Traditional budgeting in modern business

The essay below is an attempt to analyse the issue of Traditional budgeting and discusses the fact that how now-a-days formal, traditional budgeting does not prove quite apt for modern businesses. To begin with, the essay will give a brief explanation of what is a budget and what is budgeting. This will be followed by a short note on modern budgeting and there will be a concise induction on traditional budgeting. Furthermore, the essay will throw light on the strengths and weaknesses of traditional budgeting; following which it will explain and evaluate the alternatives to traditional budgeting in modern businesses.

“ A budget is a business plan for the short term-typically one year”(Atrill & McLaney, 2007) . It is mainly expressed in financial terms and it is designed to meet strategic purposes. Budgeting plays a vital role in business success as it helps in the organization’s operational planning, performance evaluation, communication of goals, strategy formation, and controlling cost which helps the organization to achieve its overall objective. But it seems it is unsuitable for the modern business. The term ‘ modern business’ stands for a business which operates in a global economy and practises all modern techniques to survive in a highly competitive environment. In today’s era of information technology, it is impossible for a business to compete globally without continuous innovation, updated information and controlled activity.

In management accounting, budgeting is quite a vast and important concept.

There are different kinds of budgeting. The essay will now focus on Traditional budgeting and its working in modern businesses.

What is traditional budgeting?

Budget is a part of strategic planning process. It lays down business objectives, targets and decides activities required to achieve these objectives. Traditional budgeting is based on previous year data, decisions, uncertain estimates and forecast (Drury, 2009). Traditional budgeting is basically one year planning which lays down targets for the business and at the end of the year these targets are compared with actual results and deviations, if any, are reported to the budgeting team which uses them as an important source of information for current year budgeting. Traditional budgeting creates boundaries for the business operations and sets targets for its employees, which motivates employees to work hard and earn rewards for their achievement.

Importance of Traditional Budgeting:

Kennedy and Dugdale (1999) in his study on budgeting found out that 99% of all companies in Europe still using formal budgeting system. Budgeting provides a direction which can be used as a framework for planning and controlling the overall activity of the business. Budgeting is often used as an important tool for controlling cost and expenditure of the business, which is very essential for an organization to survive in a competitive world. It is also used as a tool to maintain liquidity position of the firm by matching business revenue against expenditure, which gives an actual position and requirement of cash at a definite time period. Kennedy and Dugdale (2009) in his study also points out that it is the multiple function of budgeting which makes it an important tool for management. Budgeting provides a system of authorization, a means of forecasting and planning, it also provides a channel of communication and coordination through which the actions of different parts of an organization can be brought together and reconciled into a common plan. Kennedy’s study also states that budgeting serves as a tool of motivation, a system of evaluation and control, which acts as a useful source of information for decision- making.

Limitations of Traditional budgeting:

Budgeting is always being criticized for its high cost and the longer time it takes for its preparation. These two limitations are always a point of consideration for modern business organizations, which require a long working of financial managers and which incurs heavy charges on the company. In addition to this, budgeting is criticized in many other aspects as well. Dugdale and Lyne (2006) in his study on budgeting points out that budgeting being an important tool for an organization has many limitations like, it meets only the lowest targets, it uses more resources than required, it competes against other divisions, business units and departments, also it spends only what is in the budget, provides inaccurate forecasts, has motives only to meet the budget but not to beat it and finally it also avoids risk element. Bourne et al. (2002) conducted a survey on limitations of traditional budgeting in which he criticizes traditional budgeting on a number of issues. From the survey result, he pointed out the following criticisms against budgeting ; its time consuming, costly, restricts flexibility in operation, its very often focused on target and often misaligned with strategy, it focuses more on cost rather than value creation, it often encourages gaming between superiors and subordinates, it is hardly updated and is based on unrealistic assumptions and guesswork which make it unsuitable for modern business.

Traditional budgeting and modern business:

‘ Budgets have long had a bad press, but they have attracted even more flak recently for being at best inappropriate to modern business practice and at worst potentially harmful’ (Marginson and Ogden, 2005). Hope (2000), in his study on traditional budgeting, points out four important reasons of incapability of traditional budgeting in modern business. he pointed out that in modern business, innovation is more essential rather than incremental, focuses more on faster learning rather than faster working, customer focus is on product satisfaction rather than increasing sale and knowledge- sharing and use of talent given more importance, rather than physical or financial capital. Modern business requires innovation along with cost saving in order to be competitive enough to fight with its rival company.

Marginson and Ogden (2005) in his study on budgeting and innovation argues ‘ how firms are balancing the need to control costs on the one hand with the pursuit of innovation on the other’. That is, modern business is an era of global business and competition which requires continuous innovation and huge spending on R & D for its survival. And if modern business follows the budgeting tool it will restrict the business from spending a huge amount on innovation and this becomes a major criticism of budgeting. Hopes & Fraser, 1999a, cited in Ekholm and Wallin (2000) added that ‘ traditional budgeting is incapable of meeting the demand of the competitive environment in the information age’. This means, traditional budgeting is a useful accounting model with its focus on command and control but it lacks in providing useful updated information like market changes, change in taste and preference, change in technology, etc. which makes traditional budgeting unsuitable for modern business. Traditional budgeting is a time consuming process and therefore fails in reflecting changes fails in the company's organization process. As a result it ' produces inadequate variance reports leaving the how and when question unanswered'. That is, it ignores shareholders value and focuses more on short term financial numbers. It follows a risk avoiding culture and therefore faces a false sense of security as a yearly, rigid process and as being a toy of the accounting department.(Hopes & Fraser, 1999a, cited in Ekholm and Wallin, 2000). Ekholm and wallin (2000) in his study about budget found out that traditional budget seems to be a burden, and therefore must be removed from financial reports, before improving financial performance.

Dugdale and Lyne (2006) say that if companies want to meet the modern business challenges then they must dismantle their ' rigid command and control structure, which means scrapping their budget and should adopt a policy of radical decentralization and implement appropriate key performance indicators, scorecards and rolling forecast.'

Alternatives to budgeting:

Traditional budgeting is described as a " Bane of Corporate America" and a " tool of repression", by modern businesses which look for alternatives.

Rolling forecasts produced on a monthly or quarterly basis, are suggested to be the main alternative to the annual budget (Arterion 1998, Hope and Fraser 1990-20 cited in Ekholm and Wallin, 2000). Limitations of traditional budgeting give rise to many beyond budgeting techniques. Fanning (2000), in his article titled ‘ evolution or Revolution’, explained beyond budgeting as a technique that restrict gaming, focuses on other business performance in addition to financial performance and uses insightful forecasts that accurately predict company’s performance for a shorter period of time like, rolling forecast. In addition there are some better budgeting techniques like, zero based budgeting, activity based budgeting, process based budgeting and performance based budgeting. Rolling forecast serves as a best alternative to traditional budgeting, as stated earlier. In this the budget is prepared for a short period of time which ranges from a month to a year. The main advantage of this method is that it encourages the manager of a company to look ahead and review their plans on a regular basis.

Zero based budgeting is also emerged as a good alternative to incremental budgets. Unlike traditional budgeting zero based budgeting justifies and prioritizes all the activities before allocating amount of resources to them. In addition it focuses on activities instead of functional department which is a feature of traditional budgeting (Drury, 2008).

Activity based budgeting ‘ authorize the supply of only those resources that are needed to perform activities required to meet the budget production and sales volume’. This overcome traditional budgeting limitation which works on incremental basis to predict year expenses on the basis of last year expenses.

Traditional budget systems focus on expenditures.

Performance Based Budgeting focuses on final result by fixing desired performances goal to each department. The purpose of Performance-Based Budgeting is to provide a sound basis, upon which resource allocation decisions can be done; to communicate the measurable results expected to be achieved from a budget allocation; and to build a connection between budget and program performance results for the same operational unit over same period of measurement.

Importance of budgeting in modern business:

Dugdale and Hanseen (two writers) from their study on?????????????? find out that in budgeting; operational planning, performance evaluation, communication of goals and strategy formation are the important functions which help it in being alive in modern business. Ekholm and Wallin (2000) from a questionnaire survey on budgeting stated that traditional budgeting is needed in modern business as it is an important tool for maintaining internal effectiveness which is needed to maintain long term equilibrium position of the company. He also finds out that modern business still requires traditional budgeting because its targets can’t be set for the people. This means that, no control and no performance evaluation can be done. Hanseen and Van der Stede (2004) from his study on Multiple facets of budgeting finds out that there are different reasons to budgeting like ‘ market related performance (sales growth, market share) and internal operation related performance (cost effectiveness, quality), which seems to be important reason for its wide use in modern business as it will help company to achieve competitive advantage over its rival. Dugdale and Lyne (2006) as a conclusion of case study point out that budget is an important tool to set resources limit for function such as service and R&D, which will help business to make efficient use of their limited resources that will lead to success for a company in this competitive world.

Conclusion:

After a detailed study about budgeting it can be concluded here that, budgeting is an important tool for any business organization which helps the organization in operational planning, performance evaluation, communication of goal, strategy formulation and fixing targets which serve as a basis for organizational working and control. Inspite of its importance in organization, its become a matter of great concern to change or abandon traditional budgeting from modern business. It is because of some budgeting limitations which make it somehow rigid to be used in flexible and compatible modern business. It can be seen that traditional budgeting lacks in providing updated information, flexible operations, restricts huge expenditure on innovation and in addition to this, it is time consuming and a costly method, which binds a company to a 12 month agreement with budgeting expenditure and income list which restrict flexibility of modern business. On the other hand, budgeting helps modern businesses in setting their targets for the year and cost controlling measures which play a vital role in the competitive market.

So, seeing budgeting limitations and benefits to modern business, many economists and business managers suggest that traditional budgeting is an important tool which cannot be fully removed from an organization but some changes or beyond budgeting techniques like rolling forecast budgeting, zero based budgeting, activity based budgeting, process based budgeting and performance based budgeting, help in solving business organization problem.

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