

Traditional budgeting and budgetary controls weaknesses



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This answer briefs the practice of budgets in two entirely different businesses; one in a very stable and static market place and the other in a very dynamic, rapidly changing, innovative environment. Budgeting and budgetary control is commonly used in a traditional manner by most business entities in the world in spite of its manifold limitations. In a fast changing business environment, traditional budgeting need not be the only budgeting approach to be exercised in a company. There are quite a few alternatives like Zero-Based Budgeting, Beyond budgeting, Activity-Based Budgeting, etc. which are much beneficial and rewarding for a business entity.

Budget

“ A budget is a plan, expressed in financial and/or more generally quantitative terms, which extends forward for a period into the future” (Gowthorpe, 2003) . A traditional budget is usually prepared by reviewing past year’s budget and actual expenses, with addition or deduction towards extra business activities or reduced business activities planned and also by effecting changes towards changing factors, such as growth, inflation etc... It is basically to tie managers to predetermined actions in order to achieve the planned budget. It is usually based on organizational hierarchy and centralized leadership .

Benefits of traditional budgeting and budgetary controls are :-

- Income of budget period can be matched against budget period expenses to know whether operations will result in profit and how much profit.

- Actual performance can be compared with budget to know variances so that corrective actions can be taken.
- Budget based reports facilitates assessment of costs of goods and services provided and accomplishments of the business entity.

Problems associated with traditional budgeting and budgetary controls are :-

- It is futile to predict what will happen in the next 12 months Serven (cited in Banham, 2000) argued, “ The customary system of trying to accurately predict what will happen in 12 months and budgeting accordingly is an exercise in futility”.
- Most budgetary processes are costly and inefficient. It takes a long time to complete and by the time it is completed, it becomes no longer applicable as business environment has changed.
- According to Stewart (2004), there are ten reasons why budget cause problem, as shown below.

Though traditional budgeting have many weaknesses, but most companies still rely on it because of it's unchallenged position in the top division of accepted management practices (Hope & Fraser, 1999). Therefore many companies now seek to find alternatives of traditional budgeting, even some attempt to abandon it. However, it is widely delieved by analysts that as many as half the companies that attempt the overhaul become so exhausted they give up and go back to traditional approach (Banham, 2000).

Traditional Budgeting in Dynamic Business

In a business that operates in a very dynamic, rapidly changing, and innovative environment, traditional budgeting is inappropriate to exercise.

Budget is a barrier for the business because the vibrant market demands flexibility, fast response, innovation, process improvement, customer focus, and shareholder value (Daum, 2001). And it is the limitation of the traditional budgeting not to be able to fulfil these demands. The dynamic driven business should keep up with the change and adaptive to recent development to achieve success.

Hence Beyond Budgeting approach introduced. Daum (2001) argued that, “The Beyond Budgeting Model is designed to overcome traditional barriers and to create a flexible, adaptable organization that gives your local managers the self-confidence and freedom to think differently, make decisions rapidly, and collaborate on innovative projects with colleagues in multifunctional teams both within your company and across its borders.” Exercising beyond budgeting may have become the turnaround for many companies of their budgeting problems.

Beyond budgeting is about a performance management system, made up of a series of interdependent and interlocking process (Verlag, 2005). The objective is to create an adaptive system to the real world that ideally develops the business plan from the environment, i. e. growth of markets, performance of competitors, etc. Then, instead of trying to meet a negotiated number in the budget, business should try to beat this performance standard (Verlag, 2005). Thus it would not make managers feel undervalued.

The process of beyond budgeting is portrayed in 12 principles of Beyond Budgeting (BBRT, 2005). The first six ‘ process’ principles is concerning

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performance management systems that allows employees to response faster to customer needs and competitive environment. The second six ' leadership' principles provide a decentralization framework of responsibility to employees to facilitate them adapting quickly to potential events and improves their relative performance. Beyond budgeting can be exercised successfully by applying these principles and the business can be adaptive to the rapidly changing environment.

12 principles of Beyond Budgeting

Beyond Budgeting Process Principles

1. Targets Set aspirational goals based on continuous relative improvement not fixed targets
2. Rewards Base rewards on relative performance with hindsight not on meeting fixed targets
3. Planning Make planning an inclusive and continuous process not an annual event
4. Resources Make resources available on demand not through annual budget allocations
5. Coordination Coordinate cross company actions dynamically not though annual plans and budgets
6. Controls Base controls on KPIs, trends and relative indicators not variances against plan

Beyond Budgeting Leadership Principles

1. Governance Base governance on clear values and boundaries not on detailed rules and budgets
2. Performance Build a high performance culture based on relative success not on meeting targets
3. Freedom to act Devolve decision making authority to frontline teams don't micro-manage them
4. Accountability Create a network of small units accountable for results not centralized hierarchies
5. Customer focus Focus everyone on improving customer outcomes not on meeting internal targets
6. Information Promote open and shared information don't restrict it to those who ' need to know'

The benefits of beyond budgeting is it will examine targets, strategies, action plans, forecasts and management reports. Comparisons might also be made against competitors and past-year performance. It will concentrate on the key drivers of business performance. The purpose is to be alert and take advantage of new opportunities and respond to potential threats by using an advanced information system to make decisions early. Speed of action and good decisions are the result of beyond budgeting. (Hope & Fraser, 1999)

The major change required by beyond budgeting will raise some resistance to change (Verlag, 2005). Organisations will differ in scale, culture and business context. It would be challenging to demonstrate to key stakeholders that control can still be achieved without a budget (Max, 2005). Beyond budgeting may raise issues such as doubt of loosening control, giving front-line people decision-making authority, and trusting people to act in the best

interest of the business that is not easy change to contemplate (Hope & Fraser, 1999). However if these issues can be handled, the business may gain success in long term.

For example, the companies that have successfully practised beyond budgeting and abandoned the traditional budgeting system are Volvo (one of Europe's most profitable car manufacturers), IKEA (the world's largest furniture manufacturer and retailer), etc. (Hope & Fraser, 1999). Many organizations that have gone beyond budgeting found that their performance has improved once the budgeting process was abandoned in favour of more relative and adaptive means of planning, evaluating performance and control (Stewart, 2004).

Activity-Based Budgeting (ABB).

Although beyond budgeting is the most updated method, but not all companies can adapt to it. Thus the other alternative for the dynamic driven business is Activity-Based Budgeting (ABB). It aims to generate a budget from activities and resources of the company . A financial budget is prepared after preparation of an operationally feasible budget.

Advantages of ABB approach.

- It facilitates better product, process, or activity costing and decision making, and better resource allocation to support organizational priorities.
- It identifies capacity issues and makes adjustment earlier in the budgeting process than under traditional budgeting which does not track resource consumption patterns.

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- It enriches managers ability to respond to contingencies and also improves performance measurement, evaluation, and decision making (Hansen, Otley, et al., 2003).
- Thus, ABB can be a proper alternative for the dynamic company since it will provide more accurate analysis to quickly forecast the next budget compared to the traditional budgeting.

However, ABB is not without problems.

- According to Barret (2003), ABB can be difficult to understand about the rules relating outputs to resources and costs. Consequently business managers tend to be doubtful of the approach.
- Although ABB directly relates increase in the volume of an output with increases in certain activities, it does not help in linking activities with resources.
- Thus any application of one of these alternatives, whether it is beyond budgeting or ABB, must be considered thoroughly subject to the business current condition.

Traditional Budgeting in Static Business

In a business that operates in a very stable and static market place, where there is slight change in either products or demand every year, traditional budgeting still can be appropriate (Daum, 2001). Static business would not need to take a risk to change their invariable budgetary plan as it would cost higher and consume more time than usual. However if this condition continuously persisted, the business will never develop more than its current position. It could lead to boredom for the employees who seek for challenge.

As it is argued by Hope & Fraser (1999), “ Budgets are well known for reinforcing the command and control culture, constraining freedom and autonomy, and stifling the very challenges that excite prospective managers”.

As an alternative to the static business, Zero-Based Budgeting (ZBB) is introduced. ZBB refers to proposals by Pyhrr (1973); Cheek (1977) et al. to modify the traditional budgeting process in organizations in which budgeting is an incremental process in relation to the prior year’s actual expenditures. The proposed ZBB process requires each manager to justify the budget request approximating the organizational functions were starting from “ ground zero”. It entails clarifying the goals of an organizational unit as well as identifying the functions and projects it proposes to perform in order to achieve its goals. These activities are then ranked in order of importance (Flamholtz, 1983). Basically it is a systematic logical approach to allocate limited resources where they will be best used.

Benefits of ZBB are cost saving, improving services, increase self-discipline in developing budget, reduce the entitlement mentality with respect to cost increases and make budget discussions more meaningful during review sessions (LaFaive, 2003). On the contrary ZBB also can cause problems for example, may increase the time and expense of preparing budget, may be too radical a solution for the task at hand, and can make matters worse if not conducted accordingly. Moreover a substantial commitment must be made by all sectors involved to ensure that the change is followed through (LaFaive, 2003). ZBB is recommended for the static businesses in order to

improve performance. It can be useful for shaking up a process that may have grown stale and counterproductive over time (LaFaive, 2003).

Variance analysis is still the most common tools to calculate the mismatch between the planned budget and the actual performance. Based on the survey by Sulaiman, Ahmad & Alwi (2005), the common practice among local Japanese (about 71%) and local Malaysian companies (about 64%) is to investigate variances only when the variance exceeds a certain percentage. This is a typical characteristic of traditional budgeting. However it is inadequate to be used in today modern business. Thus Ramsey (1999) introduced diagnostic variance analysis, where budget variances are analysed in terms of the activity-based components that make up the variance, and evaluated in light of overall business performance. As a result of this analysis, the underlying cause of the variance is revealed, providing the necessary business insight to support strategic decisions.

In conclusion, traditional approach cannot be abandoned completely. Budgeting is still very important in the company and need serious attention in the organization in spite of its complication (France, 2006). Zero-Based Budgeting and Activity-Based Budgeting are only improvement of traditional approach. In a dynamic driven business that evolve in rapidly changing environment like today modern business ambience, beyond budgeting can be the suitable alternative with proper handling in the organization. As for the static business, ZZB can assist the breakthrough in the organization so that the business will develop more and achieve success in the future.