# Is Traditional Budgeting Still Relevant?

*Rosiatimah Mohd Isa*

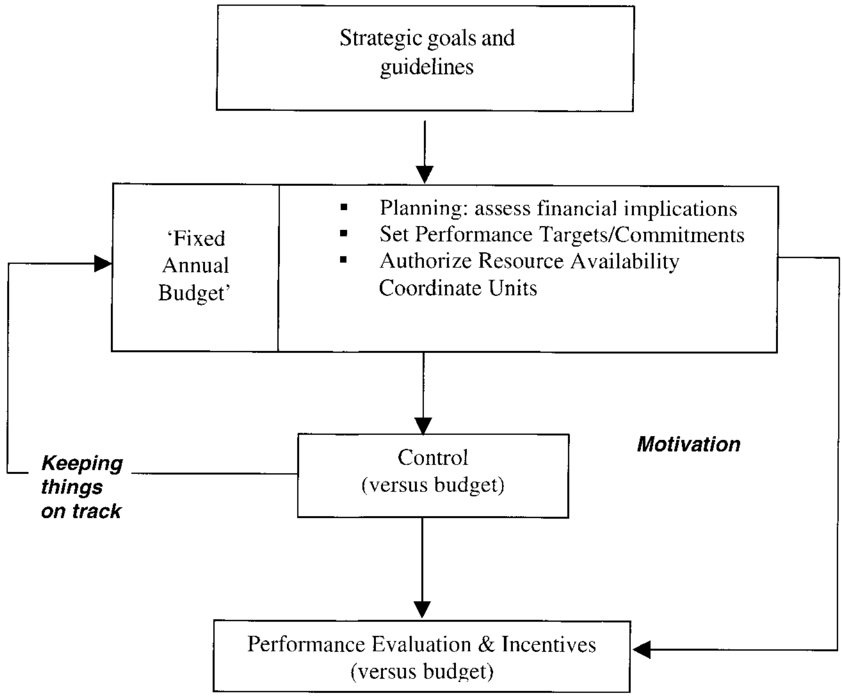
*The traditional budgeting process operates within the traditional hierarchical 'command and control model'. It is recognized as a major barrier to change companies that wish to devolve responsibility and respond more quickly to competitive threats and opportunities. In the new management model that leads to more flexible approach, the traditional budgeting has become less relevance. Many large companies have replaced their budgeting system in whole or in part with alternative mechanisms.*

## Introduction

In an age of discontinuous change, unpredictable competition and fickle customers, organizations face extremely complex and challenging environment. To compete successfully within such environment, organizational management should focus on anticipating and responding to the ever-changing needs of customers (Hope and Fraser, 1997). Few companies can plan ahead with any confidence and yet many organizations remain locked into 'plan-make-and sell' business model that involves a budgeting process based on negotiated targets and resources. The existing traditional budgeting systems, which typical internally focused, department-centered cost-minimization may not be able to adapt to the new business environment and present significant barrier to effective change. As such, it is suggested that management need to leverage their organization's knowledge in order to maintain an awareness of external developments and offer an innovative, speedy and quality service to customers (Hope and Fraser, 1997; Hope and Hope, 1997; Fanning, 1999). Therefore, a new approach of budgeting is needed to reflect today's fast-moving economy.

## The Traditional Budgeting Process Model

The traditional budgeting process operates within the traditional hierarchical 'command and control' model. Decisions, resources and rewards flow down while information flows back up. The role of line management is to operate the established facilities, systems and personnel according to senior management's rules, regulations and pre-determined targets as shown in the diagram in Figure 1.




(*Source*: Libby & Lindsay, 2003)

Figure 1: The Traditional Control Process

Libby & Lindsay (2003) also report that the traditional budgets which act as financial representations of operational details of the firm's costs and revenues are not explicitly linked to the long-term implementation of strategy. As a result, employees at lower levels do not know the linkage of their works and goals with achieving corporate strategy. Furthermore, companies usually have separate processes for long term strategic planning and annual budgeting. According Kaplan and Norton, 60% of organizations do not link strategy and budgeting. Thus, the focus and commitment to the budgeting process leaves little time for the discussion of strategy.

Budgets are now beginning to be recognized as one of the major barriers to change companies that wish to devolve responsibility and respond more quickly to competitive threats and opportunities due to its approach to manage within hierarchies. They were designed by accountants principally as a mechanism for financial forecasting, managing cash flow and capital expenditure and controlling costs. However, budgets are not ideal vehicles for management functions such as communicating corporate goals, setting objectives, continuous improvement, resource allocation and performance appraisal. Due to the existing inefficiency and ineffectiveness, they could potentially hinder and damage an organization's performance (Bunce and Fraser, 1997).

With regards to being inefficient, the traditional budget process is well known as very bureaucratic and protracted (Bunce and Fraser, 1997; Hope and Fraser, 1997; Fanning, 1999). It is claimed that budgets take up too much management time – up to 20 to 30 percent of senior executives' and financial managers' time (Libby & Lindsay, 2003). They also often involve in numerous revisions and result substantial delays (Fanning, 1999). Consequently, many of assumptions on which the budget is based no longer apply and hopelessly out of date. Thus, this budgeting process that commensurate with such significant expenditures and time consuming, adds little value to the organizations.

Its apparent ineffectiveness include parochial behaviour that encourages managers to act in ways that run counter to the best interests of their companies (i.e. lowballing targets, and inflating results, creating distrust and ill will) and consequently destroy corporate value and integrity of an entire organization. Some of the limitations of the budget identified by Bunce & Fraser (1997) and Hope and Fraser (1997) are:

i. Reinforcing departmental barriers while hindering flexibility, responsiveness and knowledge sharing
ii. Rigid commitment, constraining management to out-of-date assumptions while inhibiting both management initiative and the pursuit of continuous improvement
iii. Strengthen the traditional vertical chain of command rather than empowering the people on the organization's front line and
iv. Emphasizing cost-minimization rather than maximizing of value.

As a result, the traditional budgeting systems of centralized control, fail to give lasting improvement or generate congruent behaviour as needed by any organization in the fast paced global economy.

Concerns regarding a number of limitations and weaknesses of traditional budgeting processes are becoming increasingly widespread. A company cannot grow effectively without a well-conceived strategy and a supporting budget. According to Banham (2000) a number of Fortune 1000 companies, which include Allstate, Fujitsu, Nationwide Financial Services, Owens Corning, Sprint and Texaco, have recognized the full extent of the damage done by traditional budgeting system. They opted top-down strategic plan budgeted by department managers to replace usual bottom-up planning and multi-iterative budgeting processes. Furthermore the change of management design from the industrial age into today's emerging information era requires a better and fresh approach of budgeting.

## The New Management Design

Business organizations nowadays must be more flexible and responsive to deal with unpredictable change, hyper-competition, and increasingly fickle customers. With the traditional budgeting model that used as an agent of the restrictive type of control, it would not be possible. Knowledge has become the key strategic resource and companies are dismantling their hierarchies, delayering and decentralizing their organizations and replacing traditional 'command and control' processes with new mechanisms. They actually need a new model that effectively empowers front-line managers to make fast decisions based on current information.

The traditional worldwide, organization was built in a highly structured manner that allowed those at the top to coordinate and control the multifunctional, and multibusiness, operations as shown in Figure 2. It is also known as M-form management structure that was effective for industrial age.. The key assumption in this type of companies is that the top management would carry out the entrepreneurial tasks, while front-line managers would be primarily responsible for the operational implementation of top-down strategies.

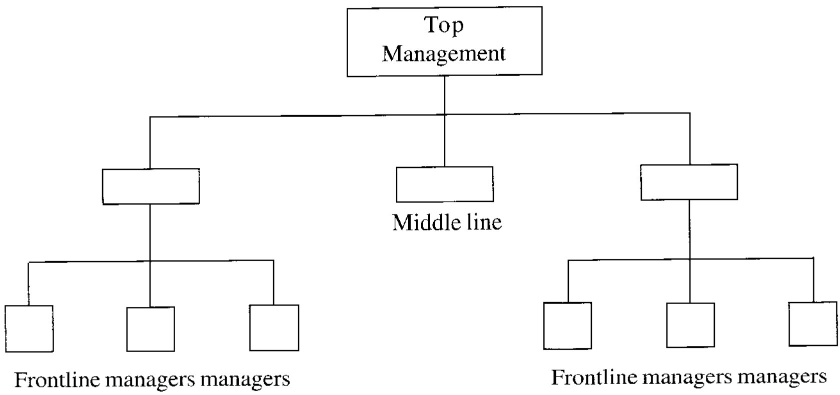
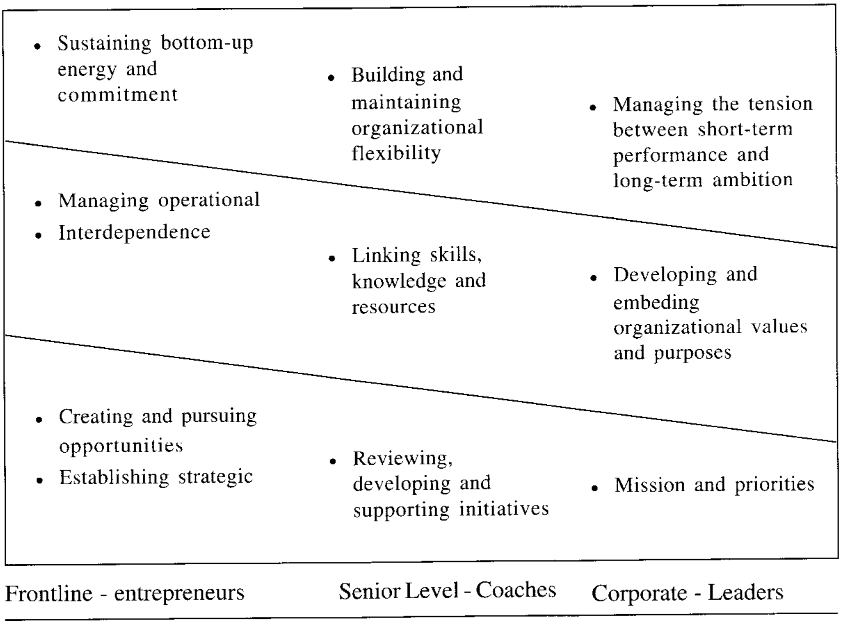



Figure 2: The Traditional Organizational Hierarchical Structure

But today, we are operating in highly competitive and rapidly changing business environment where organizations must be responsive and agile to meet demands of their customers. The key resource is no longer financial capital but intellectual capital. To meet these challenges, companies are dismantling their hierarchies, delaying, decentralizing their organizations and changing their management approaches to a new roles and tasks as suggested by Bartlett and Ghoshal (2000). In this new model (Figure 3), three core processes replace the organization formal structure:-

i. The *entrepreneurial process* that drives the opportunity-seeking, externally focused ability of the organization to open new markets and create new business.
ii. The *integration process* which allows to link and leverage its resources and capabilities to build a successful company, and
iii. The *renewal process* that maintains its ability to challenge its own beliefs and practices and to continuously revitalize itself so as to develop an enduring institution.




(*Source*: Bartlett and Ghoshal, 2000, p 795)

Figure 3: The Renewal Process: Management Roles and Tasks

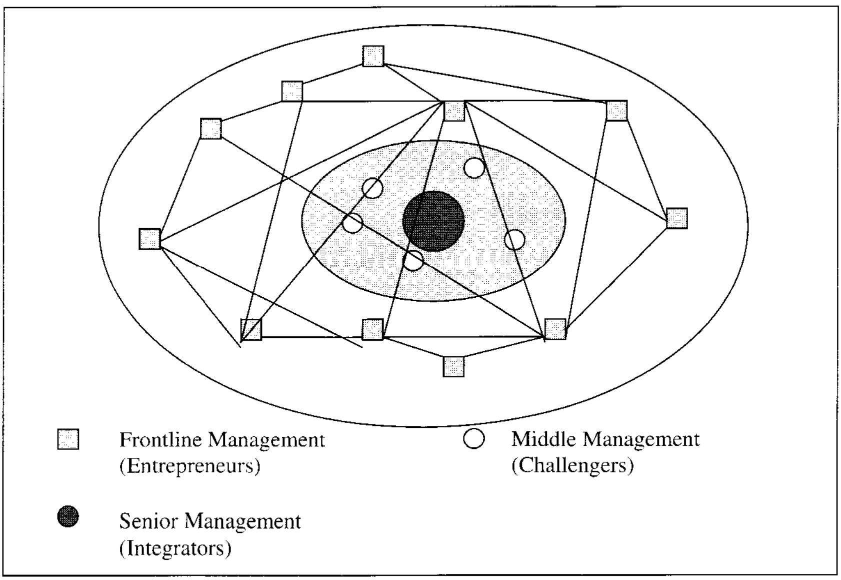
Bartlett and Ghoshal (2000) state that the renewal process is built on two symbiotic components; rationalization and revitalization to achieve continuous improvement of operational performance. The rationalization component focuses on the use of resources and strives for continuous productivity growth. The other part of renewal is revitalization that creates new competencies and new businesses, challenges and changes the existing rules of the game and the leapfrog competition through quantum leaps. The effectiveness of the renewal process ultimately depends on the ability of front-line managers to generate and maintain the energy and commitment of people within their units.

The new management model also means breaking away from the annual cycle of preparing, negotiating and relying on traditional budgets to drive managerial performance. Managers are given responsibilities for achieving targets, accountable for results, and can take decisions concerning income, expenditure and business improvements that help them to achieve their targets. The emphasis is now on looking ahead and being in a position to take advantage of new opportunities and counter potential treats by using an advanced information system to make speedy and good decisions (Hope and Fraser, 1999).

The N-form organization structure where innovation, service, quality, speed and knowledge sharing are the emphasis, treats the frontline managers no more merely the implementers but as strategists and decision makers that create and respond to new opportunities for business.

The middle line managers are viewed as the horizontal integrators, building competencies across the organization while the top management are responsible for providing inspiration and a sense of purpose (see Figure 4). Examples of modern companies adopting this transnational management or N-form organization are Asea Brown Boveri (ABB), Johnson & Johnson, 3M, Bertlesmann and Intel (Bartlett &Ghoshal, 2000).

The underlying philosophy of the new model is to maximize value rather than minimizing costs, and the focus of measurement systems on strategic performance, value-adding processes and knowledge management. Furthermore, it is more market-oriented, more organic and responsive (Brown and Atkinson, 2001). But most of all, it is a model based on trust – trusting people to act in the best interests of the firm.




*Source*: Adapted from Hope and Fraser (1997)

Figure 4: N-Form Management Structure

## A Fresh Approach to Budgeting – Beyond Budgeting

Flattening hierarchies of new design of management will simply lead to the delegation of control from strict regime of coordination and accountability with budgets as the primary weapon to more flexible approach.

Since 1998, a collaborative research group, the beyond budgeting round table (BBRT), a program of the Consortium for Advanced Manufacturing International (Europe) has been studying the problems of traditional budget and how some successful companies have been managing without them. Fraser (2000) and Hope and Fraser (1999) have reported that leading companies like Air Liquide, Svenska Handelsbanken (Swedish bank), Borealis (Danish petrochemicals company), Ericsson, Scania, Schlumberger (oil services company), SKF (the world leader in roller-bearings), Volvo and Boots (UK's most profitable large retailer) and IKEA (the world's largest furniture manufacturer and retailer) have replaced their budgeting system in whole or in part with alternative mechanisms. Their approach is based on ten key principles:-

- Targets – aim to beat the competition
- Strategy – develop strategy inclusively and continuously
- Improvement – think radically
- Resources – manage for long-term value
- Co-ordination – manage cause and effect
- Costs – manage value
- Forecasts – create the future. Control use a few key measures.
- Rewards – encourage teamwork
- Delegation – give managers responsibility and freedom to act

Hence with these principles, it seems that knowledge flows to front-line-people and back again, permitting the full potential of a radically decentralized organization to be realized. Moreover, according to Oldman and Mill (1999), the most to gain from abandoning traditional budgeting are the companies where the pressures to change are greatest and their primary competitive imperatives include innovation, speed, customer-focus, and integration.

Many of the companies that have gone beyond budgeting enrich and accelerate their information flow through the use of rolling forecasts, which are regularly revised (Hope and Fraser, 2003). The targets include only few key variables such as orders, sales, costs and capital expenditures that relatively easy and quick to compile.

According to Hope and Fraser (2003), the rolling forecasts are more accurate because of two main reasons:-

i. They are constantly refreshed by the latest estimates of economic trends and customer demand.
ii. No one has reason to manipulate the data because there are no fixed profit targets or penalties for missing them.

This seems in line with the argument put forward by Oldman and Mills (1999) that says, the accuracy of financial projections in increased when forecasting is separated from performance management and rewards and when it is base on movements in leading indicators rather than extrapolations of past results. In addition, forecasts should be more frequent and involve fewer people in preparing them.

## Conclusion

The annual traditional budget may be going the way of the dinosaur as companies introduce a new and more accurate financial model capable of linking budgeting to overall corporate strategy. It is therefore, has less relevance given today's economy. It has little predictive value and subject to gamesmanships and tend to be out of date by the time budgets are implemented. In addition, companies can no longer justify the time and effort they invest in the budgeting process and management realizes the limitations of budgets in control and motivational devices. Now, companies are using new and better approaches to steer the companies including scorecards, trend reporting, ABM (Activity Based Management) and rolling forecasts, which in some instances eliminate budgets entirely.

## Endnotes

[1] Budgetary gaming includes lie and cheat, lowballing targets and inflating results which motivate people to act in ways that run counter to the best interest of their companies.

[2] Lowballing targets refer to counter productive action that managers set targets that are easily achievable in order to gain rewards. This manipulation of budget target usually happens when budget drives compensation purely on accomplishment rather than ability to hit targets.

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ROSIATIMAH MOHD ISA, Accounting Lecturer, UiTM Arau Campus, 02600 Arau, Perlis. E-mail address: rosiatimah@perlis.uitm.edu.my