

BEYOND BUDGETING

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A viewpoint has emerged during recent years which challenges the traditional approach to the budgeting process that has operated in both private and public sector organisations since time immemorial. While there may be comfort in tradition, what is being proposed may be more relevant to the current business environment and the challenges that must be overcome by organisations facing increasing competitive pressures. Some of these ideas are revolutionary, particularly for the public sector, and indeed even for the private sector where tradition can provide a comfort blanket for managers in the increasingly demanding environment in which they operate. This comfort derives from the predictability of the traditional budgeting process.

In the opinion of an increasing number of commentators, the application of traditional budgeting processes tends to fix a company's thinking and response to events in an ever-changing world. This limits flexibility in responding to these events. There is an argument that the budget, in effect, reflects the previous year's reality. This is why organisations and their managers place an undue focus on past events rather than thinking about current and future issues within the organisation.

Today's organisations vary widely in the perception of the value provided by the budgeting process. At one end of the spectrum there are executives who consider the budget 'a tablet of stone' which gives them control. On the other hand the budgetary process is anathema to many operational managers who view the budget as being a pointless exercise and completely irrelevant to their day-to-day needs. The manner in which resources are deployed is an organisation-wide consideration, and the drive to maximise 'value-added' encompasses the finance department. In this respect it could be argued that traditional budgeting processes require finance personnel to spend far too much time on activities that are relatively low value. Given that finance staff time is a finite resource, then perhaps it would be better spent providing the requisite level of support to the operational managers within an organisation.

During recent years the business environment has become far more complex, dynamic, turbulent and uncertain. Shorter product lifecycles coupled with technological advancement has focused greater attention on innovation as a determinant of corporate success. Although organisations need to be as adaptive to change as possible, the rigidity of the budget serves only to stifle innovation and responsiveness to change. The need to comply with a fixed plan, and to manage with resources which may have been allocated more than one year earlier, act as impediments that prevent managers from responding quickly to changes in today's business environment.

The weaknesses of traditional budgeting processes have been the subject of much attention and many commentators. Hope and Fraser consider that such weaknesses include the following:

- Budgets prepared under traditional processes add little value and require far too much valuable management time which would be better spent elsewhere.
- Too heavy a reliance on the 'agreed' budget has an adverse impact on management behaviour, which can become dysfunctional with regard to the objectives of the organisation as a whole.
- The use of budgeting as a base for communicating corporate goals - setting objectives, continuous improvement etc - is seen as contrary to the original purpose of budgeting as a financial control mechanism.
- Most budgets are not based on a rational, causal model of resource consumption, but are often the result of protracted internal bargaining processes.
- Conformance to budget is not seen as compatible with a drive towards continuous improvement.
- Traditional budgeting processes have insufficient external focus.

Rolling, or perhaps monthly, budgets focus management attention on current and likely future realities within the organisational context. This is not seen as managing change, as this is outside the control of the organisation. Rather it is seen as an attempt to keep ahead of change or, strictly speaking, to be more in control of the response to the challenges facing the organisation. This importance may be emphasised in the knowledge-based economies that have developed in the western world.

Knowledge-based companies face competition which may seriously undermine any innovation. This is particularly the case as product lifecycles become shorter. Invariably, price levels are falling while the demand for increased product/service quality is rising. Organisations need to be operating at the excellent end of the quality spectrum if they are to continue to flourish and remain close to their customers. It is arguable that talented managers who seek freedom, challenge and responsibility are also in short supply. Such individuals often find traditional time-consuming and 'legalistic' budget processes off-putting. The rapid production of new solutions and strategies also depends on attracting and retaining such individuals.

In this view of the world, the traditional budget is seen as the fixed plan in accordance with which all management processes are based and aligned. This determines how managers behave and the activities and objectives on which they focus. Annual budgeting is seen as absorbing considerable management time and the monthly comparisons of actual and budgeted performance are primarily concerned with control issues. Managers will not exceed their budgets by perhaps spending necessary resources outside the planned budget cycle to react to events because their bonuses or even their jobs may be put in jeopardy.

A major problem lies in the fact that circumstances will be different when the budget

was set and when subsequent comparisons are made and management decisions required. An increasingly competitive global arena further accentuates the problem. Inflexibility is thus seen as the key failing of traditional budgeting, and companies are being urged to move towards continuous rolling forecasting to enable speedy and coordinated adaptations to actual and anticipated changes in the business environment.

Traditional budgets show the costs of functions and departments (eg staff costs and establishment costs) instead of the costs of those activities that are performed by people (eg receipt of goods, processing and dispatch of orders). Thus managers have no visibility of the real 'cost drivers' of their business. In addition, it is probable that a traditional budget contains a significant amount of non-value-added costs that are not visible to managers. The annual budget also tends to fix the capacity for the forthcoming budget period, thereby undermining the potential of activity-based management (ABM) analysis to determine required capacity from a customer-demand perspective. Those experienced in the use of ABM techniques will be familiar with such problems. However, their tasks would be much easier to perform, and their results more reliable, if such problems were removed.

THE 'BEYOND BUDGETING' MODEL - PRIVATE SECTOR

In the private sector, managers are forced to consider current and future opportunities and threats, particularly where rolling monthly forecasts of financial performance operate together with a focus on other non-financial 'value drivers'. In essence, the 'beyond budgeting' model entails devolved managerial responsibility where power and responsibility go hand in hand. The view held by proponents of the beyond budgeting model is that the following benefits may accrue as a result of its successful application by management:

- It creates and fosters a performance climate based on competitive success. Goals are agreed via reference to external benchmarks as opposed to internally-negotiated fixed targets. Managerial focus shifts from beating other managers for a slice of resources to beating the competition.
- It motivates people by giving them challenges, responsibilities and clear values as guidelines. Rewards are team-based, in recognition of the fact that no single person can act alone to achieve goals.
It devolves performance responsibilities to operational management who are closer to the 'action'. This uses the 'know-how' of individuals and teams interfacing with the customer, which in turn enables a far more rapid adaptation to changing market needs.
- It empowers operational managers to act by removing resource constraints. Key ratios are set, rather than detailed line-by-line budgets. For example, gearing and liquidity ratios may be used to show there is enough cash in the bank to meet liabilities. Local access to resources is thus based on agreed parameters rather

than line-by-line budget authorisations. This is aimed at speeding up the response to environmental threats and enabling quick exploitation of new opportunities.

- It establishes customer-orientated teams that are accountable for profitable customer outcomes. These teams agree resource and service-level requirements with service departments via the establishment of service level agreements.
- It creates transparent and open information systems throughout the organisation, which should provide fast, open and distributed information to facilitate control at all levels. The IT system is crucial in flexing the key performance indicators as part of the rolling forecast process.

THE PUBLIC SECTOR

The legal framework of public sector organisations would probably prevent such a system being introduced. As with all alternatives, the success of a particular process depends on the needs of the individual organisation. The alternative of the beyond budgeting model places considerable emphasis on the need for organisational, managerial and cultural changes in order that it may be successfully applied by organisations. This will present considerable behavioural challenges and individual managers might become overwhelmed by the complexity of decision-making in such an unregulated decision-making environment.

In the public sector, the budget process inevitably has considerable influence on organisational processes, and represents the financial expression of policies resulting from politically motivated goals and objectives. Yet the reality of life for many public sector managers is an increased pressure to perform in a resource-constrained environment, while also being subjected to growing competition. In essence, a public sector budget:

- establishes the level of income and expenditure
- authorises that expenditure, once agreed, out of the planned income
- acts as a control on expenditure and income
- communicates policies and plans
- focuses attention on the future
- motivates managers and staff.

While these issues may be common with the private sector, a number of issues arise which are specific to the public sector. For example, UK local authorities are prevented by law from borrowing funds for revenue purposes or budgeting for a deficit. If the beyond budgeting model is to allow greater freedom for managers then it will take a considerable change of mindset in the public sector to achieve the flexible agenda envisaged, especially where such flexibility would involve considerable and increased delegation to managers. One wonders therefore, from a behavioural perspective, if such managers are capable of making this change, as it would entail the adoption of a radically different approach. Local authority financial regulations also tend to prevent the transfer of funds from one budget head to another (otherwise known as virement) without compliance with various rules and regulations.

These rules (expressed in the financial regulations of public sector organisations) will be consistent with the policies of the organisation and are designed to prevent expenditure on items such as permanent staff where such costs would go beyond the budget year and represent a commitment of future resources.

Budgets in the public sector tend to concentrate on planning for one financial year ahead. Attempts are being made by UK central government, through the comprehensive spending review, to place an emphasis on the longer-term. However, considerable difficulties exist within the individual organisations that make up the public sector when creating a budget system that reflects longer-term objectives and goes beyond the annual cycle. It also remains to be seen how the relatively new system of resource accounting in central government will fit into the budgeting framework.

Traditional methods of budgeting in the public sector centre on the bid system and incremental budgeting. These approaches focus on changes at the margin and generally reflect acceptance of the budget base from the previous year. This is partly a reflection of the size and complexity of public sector organisations, but also the internal political power of large departments, which protect their positions through their relative strength. Bid systems also minimise conflict, as debate and power struggles are only concerned with the 'incremental' items. More advanced approaches are represented within financial planning systems, and include such concepts as zero-based budgeting and planned programme budgeting systems with a timeframe greater than one year.

Whether the public sector can adapt to the concept of greater flexibility - which lies at the heart of beyond budgeting - remains a matter of ongoing debate. Such an adaptation would require a mindset which not only moves away from control but also requires a reduction in the internal political power of large departments which has been at the heart of public sector budgeting for many years.

The desire to generate improved performance - essentially considered the driver for the beyond budgeting model - is present in the public sector evidenced in initiatives such as key performance indicators and 'best value' plans. But this is not matched by a desire for the flexibility inherent in the model. In terms of beyond budgeting, managers in such organisations are likely to remain constrained by the inability of their organisation to change.

CONCLUSION

We see the beyond budgeting model as having particular relevance for knowledge-based companies which are increasingly a feature of a developed economy. Other companies may see specific benefits in such a system, given the rapidly changing environment in which they also operate. These changes will not be introduced without conflict and difficulty due to the challenges faced in introducing change. Such challenges may be beyond the achievement of the public sector, due to the expression in the budget of politically-motivated policies and objectives developed

within a complex legal and financial framework. What we can say, however, is that if we are to see the successful application of the beyond budgeting model in both private and public sectors, then this must be underpinned by a considerable organisational, cultural and managerial change. Otherwise it is doomed to failure.

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FURTHER READING

1. Coombs, H M and Jenkins, D E Public Sector Financial Management, 3rd edition, Thomson Learning Press, 2003.
2. Hope, J and Fraser, R Beyond Budgeting, 1st edition, Harvard Business School Press, 2003.