Chapter

4

Beyond Budgeting

4.1 The purpose of budgets

The main purpose of budgets can be explained using the acronym **"PRIME"**.

P Planning

The budget allows managers to think ahead which is crucial as there are always uncertain events in business which may or may not occur in the future. These events must be continually reviewed and action should be taken or revised in advance rather than simply reacting to events as they occur. The budget will allow comparisons to be made against actual results and then any major differences can be investigated and adjustments can be made to the budget for the next period. This makes production more efficient, effective and economical.

R Resource utilisation or responsibility accounting

The budget will allow everyone to understand what resources are available and how they are to be allocated to different budgets. Budgets also allow managers to become responsible for the management of resources that they have been allocated in the budget, and as a result assessed on the success of resource management. This will allow comparisons to be made between managers leading to improving resource utilisation.

I Integration or coordination

The budget will allow a more efficient production of goods and services because they can be linked with one another. For example the sales department will have sales forecasts for the next year based on historical sales, pre-order sales and current market conditions. The production department should manufacture to match the sales forecast as any excess production would simply not be sold and be money tied up in finished goods. The money and other resources could have been deployed elsewhere which would have yielded sale and profit.

M Motivation

The budget will allow targets to be created for managers that they will want to achieve. This is because they may have been involved in the setting of the targets and also there may be a benefit that would be gained such a bonus if a certain level of sales is achieved.

E Evaluation

The budget will allow judgements to be made on the performance of the managers by comparing the actual results with the budget. Evaluation should not just be based quantitative achievements such as profits or sales but also qualitative achievements such as customer feedback and employee morale.

4.2 Behavioural aspects of budgeting

The behavioural aspects of budgeting are concerned with how budgets or standards effect people within an organisation. Poor performance could be attributable to the method of implementing budgets e.g. ignoring the ‘human side’ of participation or the introduction of a standard that is either unrealistic or unobtainable can de-motivate staff. This could cause a decline in productivity or efficiency.

Managers who set the budget may not be the same, as the person who has to achieve the budget, so it is important to understand how human beings behave. Too much pressure on sub-ordinates will unite them and results could actually be even worse than expected. Workers often may feel ‘victimised’ with superior’s also often using budgets as position of supremacy. Getting the balance right in terms of an ‘achievable standard or target’ is essential during the planning stage of the budgeting process. A budget should be challenging and tough but not impossible to achieve, in addition it should not be too easily achievable as workers would simply do enough to meet the targets and nothing more.

Goal congruence means making your organisation or business objectives aligned with the personal objectives of a manager or a member of staff. This is essential if you are to achieve a budget or target being set.

The following behavioural aspects could arise when implementing budgets

- ✘ Budgets maybe seen as a ‘penny pinching’ exercise rather than a good tool for cost control for managers and staff.
- ✘ Employees become united, finding excuses for not meeting targets.
- ✘ Lack of support from management may cause low motivation or morale during and after the budget process.
- ✘ Sub-optimisation or dysfunctional behaviour may occur e.g. the personal objectives of a manager or member of staff are not aligned with the business objectives.
- ✘ Budgetary slack or ‘budget padding’ e.g. wasteful spending, maybe introduced within cost estimates submitted by a manager or member of staff.

Budgetary slack or padding is a term used to describe the difference between the minimum necessary expenditure required and the actual estimate or forecast submitted. This term was used when we discussed incremental budgeting; the major disadvantage of incremental budgeting is that it compounds the problems of budgetary slack overtime. It is natural human behaviour when asked to establish a target or standard, to include an element of overspending, to ensure standards or targets are met more comfortably. It may exist due to the fear of failure or the avoidance of blame for careless overspending.

Advantages of allowing participation from staff when setting budgets

- ✓ Greater motivations for the manager and because of these targets are more likely to be met. It will also be more interesting and more involving for the manager increasing job satisfaction.

- ✓ Participation means that targets are more likely to be accepted by the manager e.g. less conflict due to setting targets themselves.

- ✓ The manager maybe more up to date in terms of the market environment and therefore the targets they set could be more realistic than if imposed centrally.

Circumstances where participation from staff may lead to poor performance

- ✘ If managers are asked to participate in setting their own budgets there is the possibility they will include "slack" or "padding" within the budget e.g. have less sales units forecast than they could realistically achieve, given a reasonable level of effort. This is the inevitable downside of human behaviour e.g. underestimate to avoid blame if they were to under achieve.

- ✘ Participation could create a slower process to formulate a budget because more consultation is required. This will inevitably increase the cost and time of formulating budgets, leading to budgets which are late or costly to produce.

- ✘ The manager could be inexperienced financially. Therefore they may not be able to contribute effectively if they were to participate. This could lead to inaccuracies when standards or targets are developed.

- ✘ In a stable environment where revenue or costs are certain there would be little benefit in allowing a manager to participate. All this would do is add to the complexity of formulating the budget which would be unnecessary e.g. with a university, central government revenue could be fixed and therefore could not be influenced by a manager.

- ✘ The manager may not understand the market or industry environment very well and therefore the targets they set could be unrealistic than if imposed centrally.

- ✘ Managers could be demotivated due to going through the motions but with no feeling of real control or influence over the budget they submit e.g. often even with participation centralised decisions will often amend variables which are included. If job satisfaction or morale is diminished because of this then performance could suffer.

4.3 The controllability principle

The controllability principle is concerned with assessing performance based upon measures that can be controlled only by a manager and omitting any items which are uncontrollable. As an example the head office or holding company could ensure it does not include and therefore evaluate a manager on the head office overhead they apportion or interest charges they apply centrally.

Arguments for the controllability principle

- ✓ It would be considered fairer by a manager if they were not assessed on costs which are not within their own control. This is likely to improve motivation and morale.

- ✓ If a manager was assessed on costs which were not within their control, it could be argued there would be little they could do about these costs any way, even if exceptions were reported.

Arguments against the controllability principle

- ✗ Political arguments may occur over such costs which are more subjective than objective when determining controllability. It is not always black and white when determining controllability from uncontrollability.

- ✗ Just because a cost is uncontrollable does not mean a manager being assessed should ignore it altogether. In the case of head office charges, lack of accountability could encourage over consumption of these resources provided centrally.

Responsibility accounting is about separating revenues and/or costs into areas of personal responsibility to assess the individual performance of a manager. A head office or holding company must ensure that it evaluates a manager on what they can influence e.g. the revenue or cost that is controllable by them, not uncontrollable.

4.4 Beyond budgeting

A philosophy that traditional budgeting methods are of little use to management, 'Score Cards' are more modern methods, in order to alleviate the traditional problems of budgeting, however beyond budgeting believes that budgeting within organisations should be banned altogether. Beyond budgeting views that because of continual technological changes we are now competing across the world rather than just in our local community.

Criticisms of traditional budgeting

- ✘ Budgets are a constraint on doing anything different because they stifle innovation and creativity.
- ✘ Budgets are costly systems and consume large amounts of management time.
- ✘ In dynamic or fast changing environments they are reflecting on the past not future.
- ✘ In dynamic or fast changing environments they are always out of dates.
- ✘ They are generally too internal in focus, ignoring external variables, which more importantly should be being monitored, for example they focus on sales targets rather than customer satisfaction.
- ✘ Creates barriers within departments due to the feeling of competition for resources.
- ✘ It is used as an appraisal tool for the performance of the manager responsible for the budget, which may not be realistic if the budget is out of date.
- ✘ Too short-term in focus as it only looks on a year at a time, this does not encourage long term wealth creation in the company as managers are only interested in meeting budgetary requirements in the current year.

Modern methods of alleviating traditional budgeting problems

- ABM
- Use of key metrics or performance indicators.
- Balanced scorecard or other approaches to performance assessment.
- Total quality management.
- Value and non-value added analysis.
- Benchmarking.
- Creativity and innovation encouraged.
- More empowerment and de-centralisation of decisions.

4.5 Key metrics or key performance indicators

The primary goal of most profit seeking enterprises is to increase shareholder value through increasing profit. Equally important to the organisation should also be the level of customer service or quality they offer to the customer or the morale of the work force or how well the staff are trained and kept up-to-date with new working practices or technology. Overtime as organisations address these issues the benefits in the longer term would mean increased profitability if more non-financial indicators or measures are monitored, controlled and used by management effectively. Non-financial indicators recognise that a constant drive to solely increase profits can ultimately be self-defeating,

Financial measures are to do with the normal things you would find within a profit and loss or balance sheet e.g. sales, costs, profit and assets. Non-financial measures or indicators are those that do not appear in any profit and loss or balance sheet, these would include ratios, percentages or absolute figures or trends e.g. market share %, market size, capacity, productivity or efficiency measures relevant to the organisation.

Key metrics or key performance indicators or (KPIs), are important measures an organisation uses to assess performance, although sometimes hard to quantify they would be objectives used to measure the success or otherwise of a critical success factor for an organisation. They can be physical quantities, money terms such as profit, sales or variances and ratios or percentages such as market share. **Critical success factors** (CSFs) are operational goals that if achieved, the business will be successful. "The limited number of areas in which results, if they are satisfactory, will enable successful competitive performance" **(Rockart and Hoffman)** or "those components of strategy where the organisation must excel to outperform competition" **(Johnson and Scholes)**

The **balanced scorecard** suggests that we view the organisation from four perspectives, and to develop metrics, collect data and analyse it relative to each of these perspectives:

- **Customer** e.g. what must we do right for our customers and what do they value?
- **Internal** e.g. what must we excel at or improve internally to satisfy shareholders and customers?
- **Innovation and learning** e.g. how can we innovate and improve value?
- **Financial** e.g. how do we satisfy shareholders and create value for them?

4.6 Management control systems

Every organisation needs a plan and with measurable objectives to achieve it. Control is needed to ensure what is intended actually comes to be. The aim of a good control system is to ensure that the right things get done, so there has to be some kind of plan, standard, budget, rule book or any other target to adhere to. Control is dependent on the receipt and processing of information in the first place to determine what measures are needed, then further information (or feedback) about actual performance to ensure targets or deliverables are met.

Feedback control 'appraisal'

Feedback is any process where part of the output of a system is measured and returned as input to regulate the systems further output. Feedback normally involves gathering information on past performance from the output of a system, comparing it to a predetermined standard or plan and using any material deviations, as a basis of improving future performance.

- Feedback can be negative (adverse) or positive (favourable)
- Feedback is based on comparing actual to a standard of performance
- Control action would be 'closing the stable door after the horse has bolted'

Feed-forward control 'prevention rather than cure'

Feed-forward control would be a system that in a pre-emptive way, reacts to changes in its environment, normally to maintain some kind of desired state. Feed-forward control systems react to future performance expected e.g. make control adjustments, before adverse conditions expected do occur.

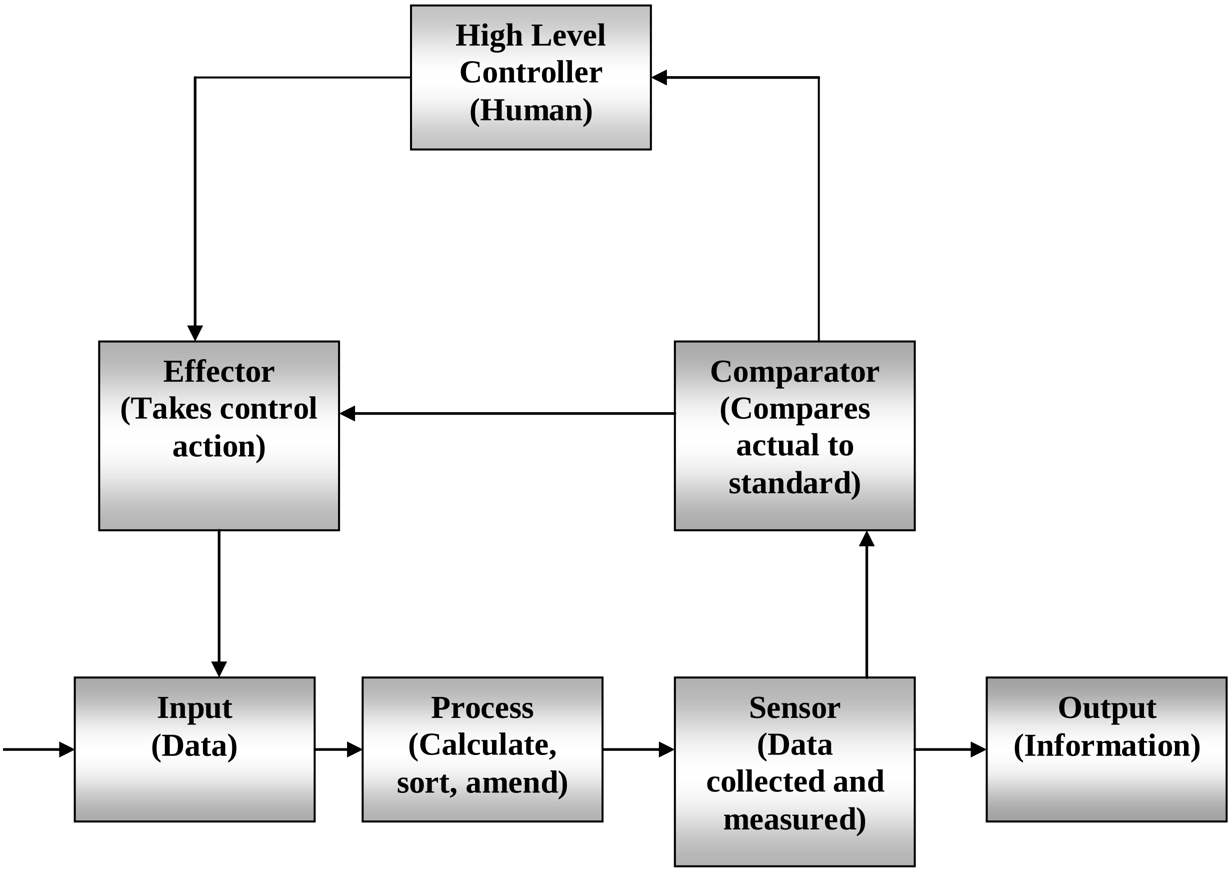
- Forecasting ahead and doing something now before the event occurs
- Examples include cash budgeting or strategic planning
- Control action would be 'closing the stable door before the horse bolts'

Open and closed loop control systems

In an open loop control (double feedback loop) system, corrective action is not automatically taken. The output of the system is measured, however environmental factors will also be considered, along with internal feedback before any control action is taken.

In a closed loop control (single feedback loop) system, the output is automatically compared to a pre-determined standard; any exceptions and control action will be automatically taken.

The 'components' of a control system (general systems theory)



- **Sensor** – This detects information it is programmed or instructed to find.
- **Comparator** – This compares results (costs, productivity or quality) against a predetermined standard or plan.
- **Effector –** This is either automatic or human action taken to correct future undesired outcomes. It uses exception reporting to achieve this, whereby exception reporting is the review of adverse differences between actual results and expected results. This information will come from the comparator.

Examples of application of the control system

People and performance (sales targets systems)	
Input	Sales being generated by sales reps.
Process and Sensor	Sales are being included in the accounting system and commissions being calculated for sales reps.
Output	The report showing level of sales and commissions earned by different sales reps.
Comparator	Comparisons are made between the target level of sales expected by sales reps and the actual results.
Effector	Sales manager takes action over those sales reps that did not meet their sales targets. Such action will be to talk to the sales reps to understand why their targets have not been met and then if necessary additional guidance and training would be given.

Managing resources efficiently and effectively (stock control)	
Input	Raw materials being delivered to a factory to go into production.
Process	The raw materials are used in the production process.
Sensor	This is a quality control procedure of the finished product to ensure it meets certain standards.
Output	These are the products themselves which are sold customers.
Comparator	Comparisons are made between the actual level of sales and actual level of production of finished goods.
Effector	The sales manager will review the level of sales and production and in conjunction with the production manager and together agree on appropriate action to increase or decrease raw materials levels to ensure that a satisfactory level of production is reached to support sales.

Key summary of chapter

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R Resource utilisation or responsibility accounting
I Integration or coordination
M Motivation
E Evaluation

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