CHAPTER 3:
SCENARIO OF CORPORATE PLANNING AND BUDGETING IN A RAPIDLY CHANGING ENVIRONMENT

3.1 EVOLUTION OF BUDGET PLANNING AND CONTROL IN THE CHANGING ENVIRONMENT

Budgeting process is evolving. Although it has changed, the change has been neither dramatic nor radical. Instead, budgeting process have gone through incremental improvements, with traditional budgets being supplemented with new tools and techniques. Figure 2 below shows the big picture on how a budget got started, grew and evolved from the 17th century of agricultural era to the 20th century of informational wave around the World.

Figure 3.1: Evolution of budgeting within the three waves of economic change

Source: Hope and Hope, 1997; Banovic, 2005.
From the figure above, it is clearly illustrated that a different breed of budgeting models and concept was mostly born in the information wave. Companies operating in information and digital era are no longer constrained by land, labour or capital as in the agricultural and industrial age. The modern economic environment is associated with a rapidly changing environment, flexible manufacturing, short product life cycles and highly customised products and services. Modern business own limited assets of the traditional kind but assemble resources as and when needed to meet customer demand. The keys to their survival is flexibility and rapid response whereby companies are able to move quickly to exploit opportunities as they arise and does not operate according to elaborate business plans. Thus, this necessitates the creation of new and advanced planning and budgeting models. Various studies also agrees that with the increase in business environment’s turbulence, companies need to change their budgeting system.

This chapter looks at the elements of a traditional budgeting and its alternative, a more advanced approach to budgeting, termed as “better budgeting” and “beyond budgeting”.
3.2 TRADITIONAL BUDGETING

According to SAP AG\(^1\) in their White Paper titled “Beyond Budgeting” (2001), the traditional budgeting model was developed in the 1920s to help financial managers control costs in large organizations.

Traditional planning and budgeting is viewed as the periodic process by which the organisation tends to define their forward operational expenditures and forecasted income. It covers a one-year period and presents forecasts that do not change during the budget cycle. Traditionally, budgets reflect historical data and are set after managers engage in a lengthy process of trying to establish what that data indicate about the future. This process is usually protracted, often due to managers’ self-interested wrangling (Van Mourik, 2006).

Traditional budgeting allows managers to build next year’s budget with last year’s expenditures and add a percent for inflation, making them justify only those incremental increases while automatically accepting current levels of spending and achievement without question. Though incremental budgeting has its advantages, the disadvantages of this technique undermine its benefit.

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
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<tbody>
<tr>
<td>• Relatively simple to use and easy to understand</td>
<td>• Unlike zero based budget, incremental budgeting assume that the activities and methods of working will continue in the same way hence it fails to take into account changing circumstances.</td>
</tr>
<tr>
<td>• The budget is stable and change is gradual.</td>
<td>• As it is merely a marking up the previous year budget, it’s too simple a method where it does not provide incentive for employees to develop new ideas/ to innovate.</td>
</tr>
<tr>
<td>• Managers can operate their departments on a consistent basis.</td>
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\(^1\) SAP AG is the largest European software enterprise and the third largest in the world, with headquarters in Walldorf, Germany.
Table 3.1: Advantages and Disadvantages of Incremental Budgeting (continued)

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Conflicts should be avoided if departments can be seen to be treated similarly.</td>
<td>• As it encourages spending up to the budget so that the budget is maintained next year. With this spend it or lose it mentality, cost cannot be reduced.</td>
</tr>
<tr>
<td>• Co-ordination between budgets is easier to achieve.</td>
<td>• The budget may become out of date and no longer relate to the level of activity or type of work being carried out.</td>
</tr>
<tr>
<td>• The impact of change can be seen quickly.</td>
<td>• The priority for resources may have changed since the budgets were set originally.</td>
</tr>
<tr>
<td></td>
<td>• There may be budgetary slack built into the budget, which is never reviewed-managers might have overestimated their requirements in the past in order to obtain a budget which is easier to work to, and which will allow them to achieve favourable results.</td>
</tr>
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</table>

In its traditional sense, budget planning is a top-down process. The mission statement agreed upon by senior executives was translated into the strategic plan by planners and handed down the hierarchy to operational managers, who prepared their budgets. Once the plan and budgets were agreed upon, all that was demanded of managers is adherence to the plan. Because the head office did not like surprises, control reports were constantly fed back up the line. If the reports showed that performance was veering off-track, new directives were issued from the head office (SAP White Paper, 2001).

The underlying thread of the traditional budgeting model was control (SAP White Paper, 2001). It ensures that management’s goals are reflected and operational activities are in line with the management’s goals. In view of this, budgeting approach has been criticised as being too bureaucratic. Various research reports allude to the widespread dissatisfaction with the bureaucratic exercise and the emphasis placed in cost-controlling that traditional budgeting is accused of having become.
Even though the traditional budgets have evolved from its original form in the 1920s and has help growing businesses manage capital resources and plan cash requirements, it is widely believed that setting targets and controlling and evaluating performance using budgets is fundamentally flawed because it directs managerial behaviour towards achieving predetermined financial targets rather than harnessing the energy of people at all levels towards continuously improving competitive strategies and customer-oriented processes.

Most organisations use a traditional budget because they are easy to put together and simplify coordination of budget assumptions across different departments. This is the simplest method of budgeting.

3.2.1 The Weaknesses of Traditional Planning and Budgeting

Neely, Sutcliff and Heyns (2001) highlighted that the starting point of any review of current practice of budgeting has to acknowledge the massive frustration with the traditional approaches. Further, they have reviewed various literatures and found twelve most frequently cited criticism of traditional planning and budgeting. It has been argued that, collectively, these weaknesses lead towards business underperformance. These criticisms are further explained below.

1) **Budgets are time-consuming and costly to be put together.**

Most budget processes are inefficient, as well as costly. In many organisations, the planning and budgeting process is said to consume 20 to 30 percent of the management time. A benchmark study by PriceWaterhouseCoopers (“PWC”) in 1995 also found that budget preparation took an average of 110 days from start to
finish and reported that profit forecasts varied from actual results by a median of 10 percent. The same PWC study also reported that budgeting costs large multinational enterprises a median of $63,000 for every $100 million of base revenue within finance departments alone.

2) **Budgets constraint responsiveness and flexibility and are often a barrier to change.**

Traditionally, attention is focused on achievement of the specific plan or budget and this resulted in organisation’s eyesight to constantly focus on how to achieve and beat the budget. In addition, budgeting has also been criticized as producing and presenting the wrong target. According to this view, the true aim of a company should not be to beat the budget but to beat the competition. In traditional approaches to budgeting, there is rarely an opportunity to amend, change or update the budget once it has been approved, should there be any changes in the environment or assumptions employed. This focus can act as a constraint, decreasing the firm's flexibility and ability to adapt and deal with new opportunities, threats or changes in customers' requirements. In addition, this mindset acts as a barrier to continuous improvement and success, because, less focus is given on how to maximize the organisation's potential.

3) **Budgets are rarely strategically focused and are often contradictory.**

Accountants employed by listed companies argued that they are unable to think strategically because of the importance attached to current-year profits, compared to long-term business health. Since budget is a financial tool which put emphasis on the firm’s cost and revenue, it tend to be internally driven and divert the
attention of the management from focus on strategy or long-term planning which
deals more with the non-financial value driver such as customer satisfaction and
long-term value generation. As such, there is a gap between strategy and
budgeting. In reality, firms are likely to separate the long-term strategy planning
and annual budget processes. Studies by Norton and Kaplan (2001) have revealed
that 60 percent of the surveyed companies do not link strategy and budgeting and
85 percent of management teams spend less than one hour a month discussing
strategy.

4) **Budgets are developed and updated infrequently – usually annually.**
Gartner Group, an industry analyst firm, has considered budgets as “a painful
annual ritual” (“Does Budgeting Have to be so Painful”, Hyperion Solution).
Budgets typically have an annual time horizon and tend to remain unchanged in
that 1-year period despite the fact that they are often out of date at the end of the
first month of budget implementation.

5) **Budgets add little value, especially given the time required to prepare them.**
A study conducted by Trapp (1999) found that more than half of the time spent by
finance department on the budget is consumed by putting data together, while only
27 percent of the time is spent on analysis. It is not uncommon for line managers
and their staff to spend weeks preparing their budget submissions; and for central
budget managers or management accountants to spend even more time
consolidating, revising and redistributing budget plans.
6) **Budgets encourage gaming and perverse (dysfunctional) behavior.**

The most recent research by Libby and Lindsay (2007) explicitly addressed the issue of budget gaming. Majority of the respondents surveyed indicated that three “gaming” phenomena occur at least occasionally: spending money at year-end to avoid losing it (the old-age “use it or loose it” syndrome), deferring necessary expenditures and negotiating easy targets (the “sandbagging syndrome”). This is especially the case when meeting the budget is directly linked with rewards and incentive payments to individuals and/or team. A vast studies have proven that majority of participants seek to maximize their personal gain during the process of setting budgets. When this mentality is pervasive throughout the organisation, the drive to improve and develop is lost.

7) **Budgets are based on unsupported assumptions and guesswork.**

Typically, traditional budgets include very limited justification of any assumptions on which they are based. Those preparing the budgets do not have to think rigorously about how they are going to deliver them. Indeed, if assumptions are not made explicit, then the opportunity to truly analyze variance is limited. Often senior managers contribute to this process by arbitrarily cutting or increasing the budgets by certain percentage.

8) **Budgets strengthen vertical command and control.**

Budgets inevitably mirror the organizational structure of the firm and thus its focus is on the performance of functions, departments, cost centers and divisions. It results in a focus on managing by the numbers. However, this contrasts sharply with the emphasis companies now place on managing processes as the cornerstone
of value creation. Leading-edge companies take a horizontal (with the customer interests in the centre) rather than a vertical view of the enterprise. In a vertical view on enterprise, budgets are generally dictated by senior management. The budgeting process provides a mechanism to ensure that these conditions are adhered to, controlling employees rather than encouraging them.

9) **Budgets concentrate on cost reductions and not value creation.**

A predominant theme in some of the literature on budgeting is that planning and budgeting processes traditionally used in many organizations are failing to deliver results. Fundamentally, the problem is that they add limited value to management of businesses. Budgets fail to measure, and can even stifle growth of intangible assets, which are now widely seen as key drivers of future cash flows and shareholder value. Budgets tend to be bureaucratic and often focus on form filling, rather than creative thinking about how the organisation is going to generate value.

10) **Budgets reinforce departmental barriers rather than encourage knowledge sharing.**

As everyone strives to achieve their own budgets and targets, there is little incentive to cooperate with others to achieve synergies.

11) **Budgets do not reflect the emerging network structures that organizations are adopting.**

Increasingly, companies are decentralizing activities and taking advantage of alliances and partnership to deliver customer service and create value. Budgets fail
to reflect such approaches; instead they promote centralized control within the confines of the individual company.

12) **Budgets make people feel undervalued.**

Traditional budgets prevent empowerment and the opportunity for employees to contribute to the achievement of strategic objectives. Often, they treat employees as costs to be minimized, rather than assets to be developed. Furthermore, it has been suggested that abandoning budgets can help attract good quality managers who value ‘freedom and autonomy’ and ‘exciting challenges’ when choosing to join.

The budgeting and planning systems and processes used in many firms today were developed many years ago for an industrial age, which was relatively static and simple to understand. Today’s economy is much more turbulent, and attempts to develop long-term, fixed plans based on old business model are naïve. Hope and Fraser (2003) argued that traditional budgeting “is out of the killer with companies’ competitive environment”. Eye-catching titles such as “The Budget - An Unnecessary Evil” (Wallander, 1999), “Bye, Bye Budget - The Annual Budget is Dead” (Gurton, 1999) and “Corporate Budgeting is Broken - Let’s Fix It” (Jensen, 2001) shows the anti-traditional budget campaign led by some budget advocators. In conclusion, traditional budgets is criticized as being out of touch with the needs of the modern business and faced growing attack from those who feel that they no longer serve modern organisations’ needs.
3.3 BETTER BUDGETING: INCREMENTAL CHANGE TO TRADITIONAL PLANNING AND BUDGETING

In response to the criticisms of traditional planning and budgeting, commentators among academicians and practitioners, offered a variety of budgeting methods for better budgeting. The literature research by Neely, Bourne and Adams (2003) uncovered five principal approaches and techniques that can aid improved budgeting and planning process. Each of the approaches and techniques are further explained below.

3.3.1 Zero-based Budgeting

Modern Zero-Based Budgeting (“ZBB”) methodology was developed by Peter A. Pyhrr for implementation at Texas Instrument in 1969. Phyrr advocated a budgeting system which requires managers to start at zero levels every year and justify all costs as if all programs were being proposed for the first time. This method is in contrast to the traditional budgeting method of incremental budgeting.

ZBB starts with a decision packages which are essentially its building blocks. The decision package is a document that identifies and describes a specific activity in such a manner that management can a) evaluate and rank the activity against other activities competing for the same or similar limited resources; and b) decide whether to approve or disapprove it. Each package includes a statement of the goals of the activity, the program by which the goals are to be achieved, the benefits expected from the program, the alternatives to the program, the consequences of not approving the package, and the expenditures of funds and personnel the activity requires. The second phase of ZBB is the ranking process. This technique allows
management to allocate its limited resources by listing all the packages identified in order of decreasing benefit to the company. The process itself follows a hierarchical structure of the company where at each level the decision packages are reviewed, ranked and consolidated, and then forwarded to the next higher organizational level for the same procedure all the way to the top. The organisation’s final budget equals the sum of the budgets of those decision packages accepted and approved by the management (Phyrr, 1977).

Looking at the complete process of ZBB, it can be said that it is a top-down, bottom-up approach to budgeting, which requires the participation of managers at all levels within the organizational hierarchy (Dean and Cowen, 1979; Banovic, 2005).

Some see ZBB as the best attempt in many years to overcome the weaknesses of traditional budgeting, because it avoids building on the inefficiencies and inaccuracies of previous years. ZBB places new objectives and operations on an equal footing with existing ones by requiring that program priorities be ranked, thereby providing a systematic basis for allocating resources. However, ZBB is not free from any problems. Many argued that in a stable business environment, ZBB is too time consuming to repeat every year, since it requires a company to build budgets from scratch, and is in fact unnecessary and unlikely to deliver significant value on a continuous basis. That is because constantly challenging assumptions in a stable operating environment is unlikely to result in new insights.
The following advantages are claimed for ZBB:

- It avoids complacency inherent in the traditional incremental approach, where it is simply assumed that future activities will be very similar to the current ones. ZBB is a systematic way of challenging status quo and obliges the organization to examine alternative activities and existing cost behavior patterns and expenditure levels (Banovic, 2005).

- ZBB encourages a questioning attitude and makes it easier to identify inefficient, obsolete or less cost-effective operations. ZBB focuses attention on value for money and makes explicit relationship between the input of resources and the output benefits (Banovic, 2005).

- ZBB forces the budget setters to examine every item and by this process, their knowledge of the operations and activities of the organisation will be increased (Banovic, 2005).

- If properly carried out, it should result in a more efficient allocation of resources to activities and departments as allocation of resources is linked to results and needs (Banovic, 2005).

The following disadvantages of ZBB need to be pointed out:

- It is a complex and time consuming process which can generate volumes of paper work. The work involves the creation of decision packages, and their subsequent ranking by top management, is very taxing, and has given rise to the cynical description of the process as “Xerox-based budgeting”.

- The ranking process is inherently difficult, as such, the use of subjective judgments are inevitable.
• There is considerable management skill required in both drawing up decision packages and in the ranking process.

• The thought of creating a budget from scratch causes considerable resistance if support groups and training programs are not in place.

ZBB finds its main use in areas where expenditures are not determined directly by manufacturing operations themselves – in areas, that is, where the manager has the discretion to choose between different activities having different direct costs and benefits. These ordinarily include marketing, finance, quality control, production, engineering, research and development, personnel and so on (Pyhrr, 1970).

Due to the large amount of time it takes to prepare ZBB, it is suggested that it should be used as a short-term budgeting method which could be selectively applied on a rolling basis throughout the organization. In many cases, ZBB has been used in situations where cost stabilization and control, or even cost reduction was necessary (Dean and Cowen, 1979).
3.3.2 Activity-based Budgeting and Management

Activity-Based Budgeting (“ABB”) approach was developed by consultants from Coopers and Lybrand Delloitte. ABB is the process of planning and controlling the expected activities of the organization to derive a cost-effective budget that meets forecast workload and agreed strategic goals. The end result of activity-based budgeting is an Activity Budget, a quantitative expression of the expected activities of the organization, reflecting management’s forecast of work-load and financial and non-financial requirements to meet agreed strategic goals and planned changes to improve performance (Antos, 1999). The approach was designed with its main objective being continuous improvement in performance and costs at each activity level of the organisation’s operations.

ABB involves planning and controlling along the lines of value-adding activities and processes. ABB is a method of budget preparation by establishing the activities that incur costs in each function of an organization, defining the relationships between activities, and using the information to decide how much resource should be allocated for each activity in the budget, rather than equally allocating the resources to all the products, as done in traditional methods. In addition, ABB separates the fixed and variable cost of each activities during the costing process. Having both a fixed budget position and a variable budget allows for monitoring of actual performance against a planned annual budget as well as an understanding of variances based around volume achievements.

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Advocates of this approach have claimed that ABB can result in cost savings of between 10 percent and 20 percent through the implementation of better methods of working and the elimination of bureaucracy. The advantages and disadvantages of the ABB method are presented in Table 3.2 below:

Table 3.2: Advantages and Disadvantages of the ABB

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>• By first balancing operational requirements, the ABB approach avoids unnecessary calculations of the financial effect of operationally infeasible plans.</td>
<td>• One potential limitation of this approach is information availability about activities, processes and resources, and the cost of creating and maintaining the information.</td>
</tr>
<tr>
<td>• The ABB approach focuses on generating budget explicitly from activities and resources. This highlights the sources of imbalances, inefficiencies and bottlenecks which allow for better product, processes or activity costing and decision making, and better resource allocation to support organizational priorities.</td>
<td>• It is difficult and costly to implement if the company doesn’t already have activity-based costing system.</td>
</tr>
<tr>
<td>• The explicit analysis of resource capacity and the increased visibility of resource consumption allow organizations to identify capacity issues and make adjustments earlier in the budgeting process than in traditional budgeting process.</td>
<td>• The ultimate success of ABB depends heavily on management’s commitment to act on the data.</td>
</tr>
<tr>
<td>• Lower level managers and employees can more easily understand and communicate budgeting information in operational rather than financial terms; activity-based budgets can lead to improved performance evaluations by specifying accountability.</td>
<td>• Due to numerous cause-and-effect linkages among the demand for products and services, activities required to provide them, and the resources required to perform the activities, the ABB system is time consuming and cumbersome to maintain.</td>
</tr>
</tbody>
</table>

Source: Banovic, 2005

The ABB approach should be used where there is a need to understand the cost impact of significant changes in levels of activity and where a decision in one part of the organization affects another in order to ensure that there is an optimal allocation of scarce resources across the business (Connolly and Ashworth, 1994).
Although ZBB and ABB undoubtedly help to improve the focus and accuracy of budget outputs, they represent valiant efforts to update the process. More importantly, Neely et al (2001) argued that both ABB and ZBB do not really address the endemic shortcomings of traditional budgeting. Basically, even with the application of ABB and ZBB approaches, the budgeting process has not changed because the “improved” budgeting process are still time consuming, result in game playing and add limited value after their first application.

### 3.3.3 Profit Planning

The focus of the profit planning model is the profit itself. Profit is an essential cost of business activity and must be planned and managed just like other costs. Successful business performance requires balancing costs and revenues. This method requires understanding of the profit wheel model for planning future financial cash flows of business units by evaluating the organisation’s operation and accessing whether an organization or unit generates and attracts sufficient cash, creates economic value and attracts sufficient financial resources for investment.

Profit planning offers the following advantages:

- **Performance evaluation.** The profit plan provides a continuing standard against which sales performance and cost control can quickly be evaluated.

- **Awareness of responsibilities.** With the profit plan, personnel are readily aware of their responsibilities for meeting sales objectives and controlling costs.

- **Cost consciousness.** Since cost excesses can quickly be identified and planned, expenditures can be compared with budgets even before they are
incurred, cost consciousness is increased, reducing unnecessary costs and overspending.

- **Disciplined approach to problem-solving.** The profit plan permits early detection of potential problems so that their nature and extent are known. With this information, alternate corrective actions can be more easily and accurately evaluated.

- **Thinking about the future.** Too often, businesses neglect to plan ahead: thinking about where they are today, where they will be next year, or the year after. As a result, opportunities are overlooked and crises occur that could have been avoided. Development of the profit plan requires thinking about the future so that many problems can be avoided before they arise.

- **Financial planning.** The profit plan serves as a basis for financial planning. With the information developed from the profit plan, companies can anticipate the need as well as facilities any need for additional capital.

- **Confidence of lenders and investors.** A realistic profit plan, supported by a description of specific steps proposed to achieve sales and profit objectives, will inspire the confidence of potential lenders and investors.

Profit plans are subjected to limitations since it is based upon estimates. Inevitably, many conditions expected when the plan was prepared will change. The profit plan requires the support of all responsible parties. Sales quotas must be agreed upon with those responsible for meeting them. Expense budgets must be agreed upon with the people who must live with them. Without mutual agreement on objectives and budgets, they will quickly be ignored and serve no useful purpose. Finally, profit plans must be changed from time to time to meet changing conditions. There
is no point in trying to operate a business according to a plan that is no longer realistic because conditions have changed. Despite the limitations of profit planning, the advantages far outweigh the disadvantages. A realistic plan, established yearly and re-evaluated as changing conditions require will provide performance guidelines that will help you control every aspect of your business with a minimum of analysis and digging for financial facts.

In theory, this approach ensures consideration of an organisation’s short-term and long-term prosperity when preparing its financial plans. However, once again, there are few examples of its practical application (Simons, 1999).

### 3.3.4 Value-based Budgeting and Management

While not an explicit replacement for budgeting and planning, Value-Based Budgeting (“VBB”) provides a formal and systematic approach for managing the creation of shareholder value over time. This management principle, also known under value based management (“VBM”), states that management should first and foremost consider the interests of shareholders in its business decisions. VBM is really a philosophy of management rather than one particular technique. Essentially, VBM combines a number of techniques such as Scenario Planning, Balanced Scorecard and Total Quality Management which primary focus is on value creation for stakeholders.

The main focus in VBB approach is that all expenditure plans should be evaluated as project appraisals and assessed in terms of the shareholder value that they will create. Management shall ensure all resources are directed towards achieving value
adding activities or services. The bottom line is that if an activity doesn’t add value to the organisation, it isn’t worth performing. It is deemed a waste of resources that could have been otherwise allocated to better or more valuable use. From a shareholder’s perspective, what matters is the ability of management to run the business in such a way that it is capable of generating money and to allocate the resources available to the company in a manner that adds value to the business. This is because returns on investment to shareholders (in the form of dividend payout) and the ability of the business to reinvest in the future (which in turn would lead to future flow of dividend payments) is dependent upon the ability of the company to generate a healthy cash flow.

Proponents of the approach note its ability to link strategy and shareholder value to planning and budgeting. In addition, VBB is cited to benefit companies in terms of improved alignment of the interest between management and stakeholders, increased corporate transparency to stakeholders, better response to deal with increased environment complexity, uncertainty and risk which will lead to consistent maximization of stakeholders’ value creation.

However, there are few demonstrated detailed techniques for implementation, so much so that the discussion on the topic appears to be of a conceptual nature. The drawback factor in the adoption of VBB may be attributed to the following:

- VBM is an all-embracing, holistic management philosophy, often requiring culture change. Because of this, large-scale VBM initiatives take considerable time, resources and patience to be successful.
• Measuring value creation is complex although the concept may sound simpler than corporate strategy.

• Performance management and balanced scorecard are very powerful management support tools and processes which requires high cost of investment.

• Measurement and assessment of the wrong things may lead to value destruction.

• The perfect VBB model and metrics has yet to be invented.

Some commentators have gone as far as suggesting that too many organizations have become focused on value measurement, rather than value management, which in turn limits the focus on value creation.

3.3.5 Rolling Budgets and Forecast

Survival in the competitive environment means that business must be flexible and innovative, largely through the development of new products and services, while simultaneously improving productivity and customer services. However, incorporating the effects of innovation into the budgets may be difficult, especially if companies are using fixed budgets that cover a specific time frame. These fixed budgets may be reviewed at regular intervals so that adjustments and corrections can be made if needed, but the basic budgets remain the same throughout the period.

In an effort to address the problem of rigid time frame in a fixed budgets, some firms, particularly those in a rapid changing industries, proposed to make budgeting and forecasting more frequent to keep pace with changing circumstances (Hayes,
Methodologies in this area include rolling budgets, perpetual planning and rolling forecasts. Rolling budgets, also called continuous budgeting, always involve maintaining a plan for a specified time period in the future. This result is achieved by adding a new time period in the future as the current time period that ended is dropped. For example, as each month passes, the one-year rolling budget is extended by one month, so that there is always a one-year budget in place (Banovic, 2005).

These approaches are seen as more responsive to the changing circumstances because they solve the problems associated with the infrequent budgeting and hence result in more accurate forecasts. They are also designed to overcome the problems associated with budgeting to a fixed point in time, that is, the year-end and the often dubious practices that such cut-offs encourage.

The advantages and disadvantages of the rolling budget and forecast method are presented in Table 3.3 below:-

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
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<tbody>
<tr>
<td>Encourage managers to think about planning as an ongoing process, rather than as a static event.</td>
<td>Like a budgeting process, managers and employees must forecast responsibly and not regard it as a routine task.</td>
</tr>
<tr>
<td>Corporate top management has access to the latest information through the budgeting process, and thus remains alerted enough to take measures to rectify problems as needed.</td>
<td>Rolling budget and forecasts have to be completed every month or quarter, instead of annually, which increases work and costs related to budgeting.</td>
</tr>
<tr>
<td>An opportunity to provide more “real-time” response to rapidly changing environment. Shortening the budget period enables a prompt review of operational plans and timely revisions of the budget, in response to the changes in the business environment.</td>
<td>Constantly changing assumptions and the financial implications of those assumptions tend to invalidate targets, along with the commitment to achieve them.</td>
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</tbody>
</table>
Table 3.3: Advantages and Disadvantages of Rolling Budget and Forecast (continued)

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<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>• In theory, the annual budgeting process is eliminated; the projection for next year is simply the first rolling forecast.</td>
<td>• The planning process can become too time-consuming.</td>
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<td>• Planning is not dictated by calendar, but can be triggered by important events and changes.</td>
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Source: Banovic, 2005

Rolling budgets and forecast is more suitable for companies that are very young or are in industries experiencing rapid growth, where actual results often vary significantly from the original budgeted amount. It is also suggested that the focus of rolling forecasts should only be the important figures of variables like orders, sales, costs, profits and cash flows, since these are the most important ones for companies’ future and should be continuously observed and updated (Lynn and Madison, 2004).

According to Neely et al (2001), the advocates of these five approaches all claim benefits in organizations that have applied them. Case studies suggest that these benefits vary from marginal to substantial improvements, in terms of cost, time, communication and control. However, critics argue that each of the approaches effectively only involve re-engineering the traditional budgeting and planning processes and do not address fundamental problems. Moreover, there is evidence to show that while some of these approaches have solid theories underlying them, they are not being well implemented or well received by the organization. Although each development in “better budgeting” has been crafted to overcome specific shortcomings in traditional budgeting processes, they often require additional effort and management resources on top of that required for the traditional process.
The literature clearly suggests that companies are looking to plan and budget more quickly, to respond to a faster changing environment, and to use less resources, thereby, freeing up management time. For some of the “better budgeting” techniques, most notably ABB and ZBB, it is questionable whether they deliver against these needs. For VBB and profit planning, the challenge is on how to implement the technique. Of the “better budgeting” techniques discussed, it appears that rolling forecasts have the most potential.

Still though, various studies and researches suggests that top management are dissatisfied with their current planning and budgeting processes, even when the companies had re-engineered them, and that many top managers within companies that have implemented one or more of these approaches believed that there were significant gaps between how financial executives had implemented the plans and how the top managers thought they should be able to apply them. Clearly, improvements are needed in the budgeting and planning process.
3.4 BEYOND BUDGETING: RADICAL CHANGE TO TRADITIONAL PLANNING AND BUDGETING

The Beyond Budgeting model was developed by two consultants, Jeremy Hope and Robin Fraser, within the Beyond Budgeting Round Table (“BBRT”)\(^3\), a research project by Consortium for Advanced Manufacturing – International (“CAM-I”), which was set-up in late 1997 by 33 companies in order to find and develop alternative tools to the planning and budgeting process (Banovic, 2005). The drive behind this project was the growing dissatisfaction and frustration of these thirty-three (33) companies with the traditional planning and budgeting process that was described in one occasion by Lionel Woodcock, CAM-I vice president for Europe, as the following (Newing, 1994):

>“Several months before year-end, the annual budgeting begins. Management translates vision of the chief executive into strategic plan by setting revenue forecast and budget goals. Departmental budgets are then prepared on the basis of an extrapolation of last year’s costs and year-to-date actuals, ‘plus a bit’. These are then reduced by across-the-board management cuts. An uneven negotiation between budgets holders and their supervisors follows and after the budget is ‘agreed’, all that is demanded is strict adherence to the plan”

Hope and Fraser (2000) concurred that,

>“In the age of discontinuous change, unpredictable condition and fickle customers, few companies can plan ahead with any confidence – yet most organizations remain locked in “plan-make-and-sell” business model that involve a protracted annual budgeting process based on negotiated targets and that assumes that customers will buy what the company made. Such

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\(^3\) The BBRT is the combination of a new concept (‘bey ond budgeting’) and a community (‘round table’). The BBRT community is an independent research collaborative that shares its knowledge across its global network through conferences and workshops.
Based on the above statement and several other statements made by leaders of multinational corporations, and motivated by research findings on budgeting practices which have reported that some organisations, most of which are high-profile companies, have abandoned the major annual budget preparation, the BBRT members realized that attempts to make incremental changes to improve the budgeting system by introducing zero-based, activity-based or faster budgeting are not solving the problems caused by the fast-changing business world.

Thus, they systematically investigated each case against traditional budgeting and conducted research at several organisations that fully or partly abandoned their budget and found that there is more to it than just dismantling the traditional budgeting system. They noticed several important changes in the management principles and practices used by companies that are managing without budgets (Banovic, 2005). From these insights, the BBRT members worked tirelessly to change the underlying culture of “contract, compliance and control” embedded in the traditional budgeting. As a result, they have developed a generic model that is based on twelve principles to create a flexible a responsive management model with an underlying culture of “responsibility, enterprise and learning”. In the “ideal” beyond budgeting organisation, all twelve principles have been fully implemented. The first 6 principles concern creating a flexible organisational structure in which authority is devolved to employees. Principles seven to twelve deal with designing an adaptive management process for a flexible organisational
structure. The twelve beyond-budgeting principles are described underneath in Table 3.4 (Hope and Fraser, 2003; Waal et al, 2004; Waal, 2005).

### Table 3.4: The 12 Beyond Budgeting Principles and Practices

<table>
<thead>
<tr>
<th>Principle 1: A self-governance framework</th>
<th>Creating a flexible organisational structure</th>
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<tbody>
<tr>
<td>In beyond budgeting organisation, the hierarchical organisational structure is subdivided into smaller, self-managing units. The traditional control system with many rules and procedures is abandoned. Managers have the authority to run their unit as they see fit. The hierarchical structure is used only if decisions have to be taken that affect all units. Because the self-managing units are small, organisations structure is less complicated and therefore more flexible.</td>
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| Principle 2: Empowered managers | Organisational members have the freedom and opportunity to act at their own discretion. There are no tight controls that restrict people in their room to manoeuvre. Managers of self-managing units act within the values and strategic boundaries as set by the senior management. Managers are responsible for both short and medium term goals and can decide for themselves on how to achieve these goals. |

| Principle 3: Accountability of dynamic outcomes | People in the beyond budgeting organisation are responsible for achieving competitive results, not for achieving the pre-set targets for a department or function. Managers get their evaluation after it is known what they have achieved compared to what they could have achieved, given the circumstances. The desired results are set dynamically (i.e. they can be adjusted throughout the year) and thus not beforehand because that would discourage people to achieve more than the preset targets. |

| Principle 4: Network organisation | The beyond budgeting organisation is structured in such a way that self-managing units form independent, customer-focused entities. These entities focus completely on the market and delivering value to customers. They adapt quickly to changing customer needs as well as unexpected opportunities and threats in the market. The market is the determining factor and not the traditional hierarchical planning, budgets and control. |

| Principle 5: Market coordination | Services from central support units (like HRM and ICT) can be purchased by the self-managing units on the basis of service level agreements. Each unit can decide for itself whether it wants to use the services from central support or whether it wants to hire external support. The central support units are in this way challenged to deliver high quality and cost-efficient services. |

| Principle 6: Supportive leadership | The organisational members are encouraged to achieve stretching goals and coached by senior managers in obtaining these. The managers of self-managing units are allowed to take risks and make mistakes, without directly being punished for it. The senior managers can act as mentors who coordinate the relations with and between unit members. |
Table 3.4: The 12 Beyond Budgeting Principles and Practices (continued)

<table>
<thead>
<tr>
<th>Designing an adaptive management process</th>
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<tbody>
<tr>
<td><strong>Principle 7: Relative targets</strong></td>
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<td><strong>Principle 8: Continuous strategy setting</strong></td>
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<td><strong>Principle 9: Anticipatory systems</strong></td>
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<td><strong>Principle 10: Resources on demand</strong></td>
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<td><strong>Principle 11: Fast, distributed information</strong></td>
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<td><strong>Principle 12: Relative team rewards</strong></td>
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</tbody>
</table>
It is important to note that the “Beyond Budgeting” does not offer any special methodology. It is a management philosophy represented by a set of best practices, from organization design and devolution of authority to planning and performance management, which companies that have abandoned the traditional budgeting model in one form or another, are now using to respond to continuous market change, unpredictable competition and increasing customer demands (Banovic, 2005). When concrete implementation is concerned, companies adopting “Beyond Budgeting” model tries to construct a superstructure to the models of the “Better Budgeting” concept. For example, companies may adopt a benchmark targets which are relative to the competitors or use a rolling forecast thereby continuously being self-adjusting to the external environment without losing sight of the business strategy. The main thrust behind Beyond Budgeting model is that an organization should not programme its activities in the form of a rigid plan locked into an annual cycle. But, budgets may still have a role (CIMA, 2007).

The advantages and disadvantages of the Beyond Budgeting model are presented in Table 3.5 below (Banovic, 2005):

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
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<td>• It offers a great deal of support to the decentralized type of companies that want to devolve the power of decision making to frontline managers and employees.</td>
<td>• There is no standardized recipe for the Beyond Budgeting model. It is simply a set of best practices used by advanced companies that managed to successfully deal with certain shortcomings of traditional budgeting. This means that each company has to find its own combination of management tools and customize them to their internal budgeting system to make the model works.</td>
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<tr>
<td>• They models results from various attempts of companies trying to overcome the dissatisfaction with traditional budgeting in today’s business environment, which guarantees practical usability.</td>
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Table 3.5: Advantages and Disadvantages of Beyond Budgeting (continued)

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Companies adopting the principles of beyond budgeting model have shown tremendous improvement in financial results and organisational’s value.</td>
<td>• The Beyond Budgeting model is difficult to implement. It involves a complete overhaul of the organisation’s system and requires harmonization to not only the budgeting system but also radical change in the organizational and cultural environments.</td>
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<tr>
<td></td>
<td>• There are only a small number of companies that have decided to implement the Beyond Budgeting models and even fewer of those that managed to complete the process all the way.</td>
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Companies that operate in a in a business environment that is market led, highly competitive and unpredictable, and in which intellectual capital is the key strategic resource; and which have already successfully implemented various management tools like the Balanced Scorecard, Activity-Based Management and Rolling Forecast, should be the ideal candidate for the Beyond Budgeting model. In many cases, implementation of beyond budgeting model, is simply managing the transformation of culture, that is, creating a shared vision of the future, rather than about changing the way numbers are compiled and analyse (Better Budgeting: A Report, 2004).
3.5 BUDGETING IN PRACTICE

Budgeting, despite being proven to effectively act as one of the building blocks of management control system, was commonly viewed as a restriction of companies’ flexibility and competitive ability. Yet, despite various criticisms, budgets are in fact alive and well, rather than becoming obsolete. Research in organisations seems to suggest that traditional budgeting remains widespread. Kennedy and Dugdale (1999) claimed that as many as 99 percent of European companies have a budget in place and no intention of abandoning it. One reason that budgets are retained in most firms is because they are so deeply ingrained in an organization’s fabric (Scapens and Roberts, 1993). Companies regarded the budgeting system and the accompanying processes as indispensable. According to a European economist Beatrice Loom-Din, “The budget is the sole corporate task that goes in depth and detail through the entire organization.” Otley (1999) stresses the importance of budgeting in contemporary organisations by suggesting that budgeting has traditionally been and still is one of the few techniques capable of integrating the whole gamut of organisational activity into a single coherent summary and that “the budgeting process still represents the central coordinating mechanism (often the only coordinating mechanism) that most organisations have. It is therefore not to be discarded lightly”. Nevertheless, a recent survey of Finnish firms found that although 25 percent are retaining their traditional budgeting system, 61 percent are actively upgrading their system, and 14 percent are either abandoning budgets or at least considering it (Ekholm and Wallin, 2000).

Recently, arising from the active campaign from proponents of “beyond budgeting” (Hope and Fraser, 1997, 1999, 2001, 2003), Lyne and Dugdale (2006) conducted a survey of companies in the South-west of England to gauge changes in budgeting
practice and shed light on whether companies are following the call to move “beyond budgeting”. 40 companies from the industrial and service sectors were represented in the survey and it was revealed that all the companies prepare budgets. Surprisingly, the study also revealed that the budgeting practices of these 40 companies were a traditional approach, almost textbook pattern. Typically, the budgeting process starts four to six months before the financial year with frequent revisions of the budget during the process. Most companies report month and year-to-date comparisons between budget and actual results and many companies report previous year data for comparison. Revisions of the budget during the year are infrequent and most companies prepare separate forecasts, usually every month and usually for the remainder of the financial year. 34 respondents agreed or strongly agreed that top managers drove the process although 23 respondents also thought that junior managers had a major input. Over half the respondents felt here had been changes in the past five years but these were not driven by the “beyond budgeting” movement. Changes usually related to revised organisation structure, greater involvement of junior managers, more sophisticated techniques or change in emphasis. Generally the change was toward more sophisticated budgeting, and, in some companies, financial controls had been tightened. One company had actually adopted “beyond budgeting” in abandoning the budget but, following several profit warnings, had returned to more traditional methods. Most respondents felt that traditional budgeting and standard costing had become more important. Although there is a danger of bias in respondents' perceptions of increasing importance over time, the sheer weight of respondents indicating increasing importance for non-financial performance indicators seems likely to reflect a real change. Greater importance for the balanced scorecard compared with other techniques such as ABC and Economic Value Added.
confirmed this general impression. It seems that traditional budgeting is now more likely to be combined with increased use of non-financial indicators. However, this does not seem to be signaling the demise of traditional methods or the rise of “beyond budgeting”. 37 of 39 respondents continued to see budgets as fairly, very or extremely important, and for all the usual reasons: but especially performance evaluation, control and planning. Budgets are also considered important for co-ordination, communication and authorisation but less so as a means of motivating managers.

Interestingly, the same is true in the Asian region. Sulaiman, Ahmad and Alwi (2004) examined studies conducted in four Asian countries on the practice of management accounting and control. They found that for the period under review, budgets are still widely used and practiced in these countries as a planning, control and performance evaluation tool.

In Singapore, for example, about 95 percent of the 174 companies surveyed by Ghosh in 1984 (Ghosh et al., 1987) used budgets as a financial control tool. Another survey conducted in 1996 revealed an increase in the use of budgets by Singaporean companies when 97 percent out of 109 companies surveyed reported the use of budgets (Ghosh and Chan, 1996). Furthermore, all of the 106 companies said “yes” to budgets being used as a tool to evaluate performance. Ghosh and Yoong’s (1988) study comparing the management accounting practices of 64 multinationals and 110 local firms in Singapore also revealed consistent results. 97 percent of the multinational firms and 93 per cent of the local firms reported that they used budgets. Thus, it can be concluded that from the period under review by Ghosh et al, the use of budgets in Singapore, over the years, has not diminished.
Malaysian companies also report a high rate of use for budgets. Abdul Rahman et al. (1998) in their survey reported that 98 percent (out of 48 manufacturing firms) of the companies used budgets. Sulaiman et al. (2002) surveyed 61 companies in the industrial and consumer products sectors of the Kuala Lumpur Stock Exchange’s (KLSE) main board and found that 98 percent of the survey respondents used budgets. When asked to indicate the extent to which they agreed with participative budgeting, 58 percent in the Sulaiman survey and 60 percent in Abdul Rahman’s survey said that budget holders should not have too much influence in determining their own budgets. On whether or not budgets should be used as a performance evaluation tool, 63 percent of the respondents in both Malaysian surveys agreed that top management should judge a manager’s performance primarily on his/her ability to meet the budget.

In India, Anderson and Lanen (1999) examined the use of budgeting procedures, firms’ budgeting philosophy and involvement of various levels of managers of 14 firms (seven internationally oriented firms and seven domestic oriented firms) in India. They found that economic reforms had led to an increased use of standard budgeting and planning procedures since 1991. Second, firms set more accurate budgets in 1996 as compared to 1991. They suggest that this may be due to the manager’s increased involvement in and understanding of the firm’s strategy as well as decreased government intervention since the liberalisation of the Indian economy in 1991. Third, plant managers in their survey tend to be more involved in budgeting than in strategy formulation. The reverse holds true for divisional managers; they appear to be more involved with strategy formulation than budgeting. Additionally,
the only discernible difference between the domestic and internationally oriented firms is the extent to which they used cost data to develop budgets. Internationally oriented firms seem to put less emphasis on cost data to prepare budgets. In 2001, Joshi surveyed 60 large and medium size firms. 100 percent of the respondents indicated that they used budgets for planning day-to-day operations and cash flows. 93 percent said that they used budgets for controlling costs and 91 percent reported that they used budgets for planning financial position. Joshi (2001)’s study also revealed that Indian firms perceived budgeting to be one of the more important management accounting tools in the future.

While the use of budgets in India, Malaysia, and Singapore remains high, there is very limited use of budgets in China. An interesting study quoted in Bromwich and Wang (1991) on a survey of 81 accountants in China (on the perceived practical value of various management accounting techniques) found a mere 4 percent perceived operational budgets to be useful. Bromwich and Wang justified that the low percentage is due to the fact that many Chinese accountants did not regard sales or production planning as their responsibility. This is primarily because Chinese state enterprises were essentially production units under the purview of an industrial ministry or an administrative corporation (Bromwich and Wang, 1991). Another study by Firth (1996), examining the diffusion of management accounting practices in foreign partnered joint venture (JV) firms, also looked at the budget use of various types of enterprises in China. Firth’s (1996) study coverage an extensive sample where he surveyed 535 foreign firms, 456 foreign partnered JV firms, 432 Chinese partner firms and 370 state owned enterprises (SOE). He found that while the production budget appears to be important to all four types of firms, the cash/working
capital budget, the sales and profits budgets have moderate use amongst the SOEs and the Chinese partner firms. Middle management’s participation in the preparation of budgets, across the four types of firms, is rather limited. Only 45 and 49 percent of the foreign partnered firms and foreign partnered JV firms, respectively, reported some kind of participation. The percentages for Chinese partner firms and SOEs remain low (at 20 and 11 percent, respectively). Consequently, managers of SOEs have few discretionary decision-making responsibilities.

It is evident from the above studies that the use of budget is still prevalent in many countries, regardless developed or developing countries; and budgeting practices remained fairly traditional. However, as a result of competitive and dynamic marketplace, companies are refining their budgeting practice and indeed, no single budgeting method prevails in large organizations. Companies tend to pick and choose from a blend of different budgeting approaches, from traditional methods to ABB, according to their individual circumstances. Nevertheless, despite the range of techniques, most budgeting processes and planning requirements are the same for all companies.