

Budgeting

Are budgets still needed? **David Dugdale** and **Stephen Lyne** investigate whether companies have heeded the call to scrap them and find that, in most organisations, they are still alive and kicking.

In recent years the use of budgets has been roundly criticised. Some writers have suggested that companies need to move beyond budgeting entirely (*see panel*). This led us to investigate whether these ideas have actually had an effect on businesses.

We surveyed financial and non-financial managers in 40 companies and followed these up with interviews in eight of them. Our main conclusion is that budgeting is alive and well. All the companies in our survey used budgets and, generally, both financial and non-financial managers thought they were important for planning, control, performance measurement, co-ordination and communication. The use of budgets for motivation was less well supported. There was almost no difference between the responses of financial and non-financial managers – if anything, non-financial managers valued budgets more.

To find out how problematic they found their budgets, we made 20 critical propositions. For example, we asked whether managers agreed that there were too many budget games and too much budget padding, and whether budgets led to buck-passing and so on. Our respondents tended to disagree with the propositions. In only two areas did more than half of the financial managers agree or strongly agree that budgets were problematic. These were that:

- ☐ Budgets are too time-consuming.
- ☐ Managers might be constrained by budgets and delay necessary actions.

Non-financial managers were even less concerned here – perhaps because they don't have to spend as much time working on budgets.

Our visits to companies confirmed the importance of budgets. They also

revealed the importance of understanding budgets in specific contexts. Typically, large companies have complicated, tiered structures. Business units usually report to a managerial level that, in large companies, reports to a still higher level. They typically comprise profit and cost centres and can be complex. Two companies in particular provided excellent examples of this complexity and the case studies in the panels on the following pages show how managers organised their businesses to promote motivation, co-ordination and control.

The two case studies and the results of the questionnaire survey show that most organisations use budgeting as part of a whole package of control systems. All 40 companies in our research employed budgets and, in a previous study of UK manufacturing companies, 40 out of 41 respondents had budgets.¹ Additionally, the financial controllers and finance directors we interviewed said they regarded budgets as a key element in their mix of structural and procedural planning and control mechanisms. We believe that there are

BEYOND BUDGETING – THE BACKGROUND

The Beyond Budgeting movement began as an attempt to design advanced budgeting systems. But their contact with innovative companies, especially Svenska Handelsbanken, persuaded consultants Jeremy Hope and Robin Fraser that companies would be better advised to abandon budgeting altogether. Their ideas led to the formation of a Beyond Budgeting Round Table, which included a number of large UK companies. Recently other academics – notably, Robert Kaplan and David Norton of Harvard Business School – have also suggested that companies might “blow up the budget”.

Hope and Fraser published a series of articles in *Management Accounting* calling for companies to move beyond budgeting and replace it with a range of indicators and techniques. They see the use of budgets as part of a performance contract as a pernicious practice, claiming that it leads to numerous problems. They include the following:

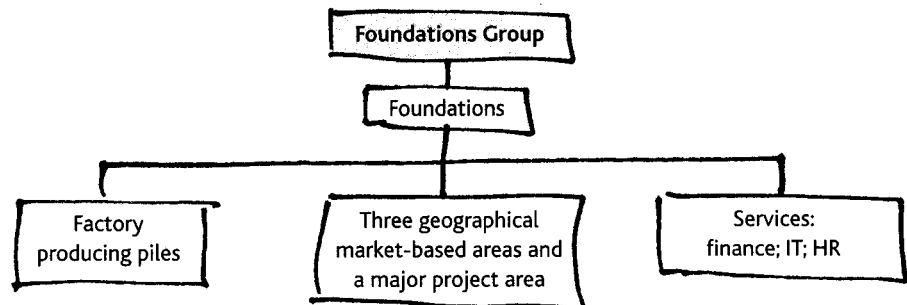
- ☐ Meeting only the lowest targets.
- ☐ Using more resources than necessary.
- ☐ Making the bonus – whatever it takes.
- ☐ Competing against other divisions, business units and departments.
- ☐ Spending what is in the budget.
- ☐ Providing inaccurate forecasts.
- ☐ Meeting the target, but not beating it.
- ☐ Avoiding risks.

Management accountants recognise these problems, but Hope and Fraser feel that they are now so serious that they are preventing companies from competing effectively in globalised, deregulated markets. They say that, in order to meet modern challenges, companies must dismantle their rigid command-and-control structures, which means scrapping their budgets. They should instead adopt a policy of radical decentralisation and implement appropriate key performance indicators, scorecards and rolling forecasts.

CASE STUDY 1 FOUNDATIONS

Foundations reports to a corporate centre, Foundations Group, which reports to a UK-quoted, corporate holding company. Within Foundations there are two production facilities that manufacture concrete piles for construction projects. The projects are won and delivered by three geographical areas and a fourth area deals specifically with major projects.

Foundations' structure is set out below. Areas are expected to deliver target margin. They receive product from the factory at full (absorbed) cost and are expected to cover this cost and the cost of the heavy equipment needed in construction operations. There is a group of central services that support the factory and marketing areas and each other.



Foundations Group expects budgets to be realistic. Any improvement plans have to be supported by specific, timed actions. Improvements in capital employed must not be merely for year-end window-dressing purposes. Our interviewee emphasised flexibility, especially in the four areas, where spending above budget is encouraged if it helps to achieve sales and margin targets. But flexibility is less easy to achieve in cost centres. For example, the IT manager had to be persuaded to act when it meant overspending his budget. The factories are controlled using standard costs based on specified processes and transfer prices that permit slight over-recovery of overhead costs.

We were struck that decentralisation extended right down to market-facing areas responsible for delivering margin targets. The group exercised control through a number of related systems emphasising control of outputs (sales and gross margin) in the sales areas, processes in the factories and inputs (budgeted resources) in the support areas.

Foundations faces complex co-ordination and control issues. It has very different functions: four marketing areas and two factories supplying the marketing areas and service providers that support the production/construction units and each other. There are sequential relationships – for example, from factory to sites – and reciprocal relationships – for example, IT to HR to IT, etc – and it is taken for granted that budgets are a tool for co-ordinating activities across the factory, marketing areas and service centres.

two reasons why Hope and Fraser want us all to abandon budgets:

- Svenska Handelsbanken's influence: "Our greatest source of inspiration has been the philosophy of radical decentralisation as exemplified by Svenska Handelsbanken."²
- Their focus on the relationships between operating units and the corporate centre.

It is known that banks and other financial institutions are prime candidates for decentralisation. Henry Mintzberg observed that the Bank of America could achieve a 600-branch span of control by using "all kinds of rules and regulations and training and indoctrination programs for branch managers." (*Structure in Fives: Designing Effective Organizations*, Prentice Hall International, 1983.) Similarly, Norman Macintosh noted the comprehensive control system at Transamerica Finance Corporation where "branch managers experience a great deal of freedom to run their operations according to the standard operating procedures, while healthy performance bonuses and frequent inter-branch competitions with exotic prizes keep branch managers from stagnating." (*Management Accounting and Control Systems*, Wiley, 1995.)

Like other banks, Svenska Handelsbanken specifies the boundaries of branch managers' discretion and then uses competitive devices such as branch league tables to motivate people. This approach can be successful in "pooled" organisations where there are similar, independent units.

Effective though these methods are for banks, it does not follow that the same radical decentralisation can be adopted by all organisations. Hope's and Fraser's recommendations are aimed

largely at revising the relationship between the centre and the operating units by emphasising output controls using a limited number of performance indicators. For example, Swedish wholesaler Ahlsell has more than 200 decentralised profit centres and the "key indicators for the sales units are profit growth, return on sales, efficiency (determined by dividing gross profit by total salary cost) and market share".²

Our organisations have considerable internal differentiation and complexity

and we believe that they find budgets help to manage this. Branches of Svenska Handelsbanken probably do not face complex internal co-ordination problems, but, even if they did, Hope's and Fraser's research would focus not on their internal problems, but on the role of budgets in mediating the relationship between the local units and the corporate centre.

We think that the apparent conflict between our findings and those of Hope and Fraser can be explained by our focus

CASE STUDY 2 FROZEN FOODS

Frozen Foods is part of a privately owned European holding group with operations in Europe and the UK. It is a largely autonomous UK company that supplies frozen food to local authorities and healthcare organisations, and to individual customers through a premium service called Your-Food. A recent acquisition means the company now has a Quick-Food profit centre producing pasties, pies and similar products, often sold at roadside service outlets. Lastly, it has a profit centre that provides support services such as transport and refrigeration to the other profit areas.

Frozen Foods has a similar structure to that of Foundations. Market-based profit centres focus on marketing, selling and delivering services. The factories are cost centres delivering products to the commercially orientated marketing and service units and the operating departments are supported by central service functions such as HR and IT. In one respect Frozen Foods is more complex than Foundations because its support services profit centre serves the other profit centres. This is important in delivering a strategy that focuses on value-adding services for individual customers. The support services centre provides its services at a transfer price. Generally, respondents preferred transfer prices to be at arms-length, but Frozen Foods was different. Our interviewee emphasised the importance of a relatively high transfer price to prevent the delivering profit centres from giving the service away.

Frozen Foods is interesting because its management has chosen not to concentrate on production profitability. Instead, it identified services as the primary value-adding part of the business and charged commercial profit-centre managers with generating contribution margin over and above the (variable) cost of production and attributable marketing, selling, distribution and service costs.

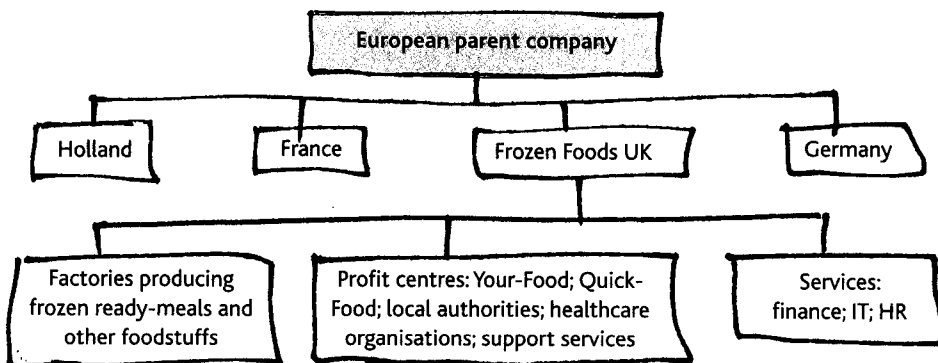
Like Foundations, Frozen Foods uses a combination of control and co-ordination systems. There is standard (variable) costing in the factories, target margin in the market-facing commercial areas and budgeting to provide overall control of resources. A specialised support services centre, supplying its services at managed transfer prices, is an integral part of company strategy.

either trading with other parts of their groups at arms-length transfer prices (Foundations) or having little inter-group trade (Frozen Foods). Both control their revenues and the bulk of their costs, so they are natural business units.

Our research suggests that, in general, organisations do decentralise – they delegate authority to business units and continue to decentralise even within those units. There are market-based areas at Foundations, product/market centres at Frozen Foods and similar structures in business units at other companies we visited. But there are limits to this process. It would, for example, be silly to think about separate factories for the market-based areas at Foundations or for the profit centres at Frozen Foods.

We also studied the use of output controls of decentralised units (target contribution, margin or profit). These arose at two levels. First, the business units themselves were expected to deliver profit targets and, second, within the business units, market-based operations were charged with delivering contribution or margin. In theory, the senior management team doesn't mind how the contribution, margin or profit is delivered, as long as it's ethical. Indeed, one of our interviewees pointed out that, if managers are responsible for output targets, they have to be given operational flexibility. It's illogical to set an output target and specify in detail how to achieve it. Managers might follow the specified actions but fail to meet the target, or they might achieve the target without following the specified actions.

Our evidence supports this observation. Where senior managers curtailed the autonomy of business units tensions surfaced and, within business units, decentralised marketing



on managing operating units and their focus on managing the relationship between operating units and the corporate centre.

Our research raised several issues. The first of these perplexed us when we analysed the data from our case studies: what is the best the unit of analysis? This led to three related issues: the degree of decentralisation that might be possible; the use of financial output measures in evaluating and motivating the managers of decentralised units; and the control

and co-ordination systems needed to manage the business units.

Why are Foundations and Frozen Foods designated strategic business units? Couldn't their market-based areas and divisions, responsible for delivering margin, be the focus for analysis instead? Perhaps it's because these units depend on supplies from factories and support from central services, and because their managers do not have sufficient control. On the other hand, Foundations and Frozen Foods are autonomous units,

operations were accorded operational flexibility. So we agree with Hope's and Fraser's main thesis that, if the corporate centre sets output controls for autonomous, decentralised business units, the additional use of tight budget controls can be counterproductive.

If output measures are key to controlling autonomous units, matters are less clear within the units themselves. We found that limits to decentralisation meant that managers needed a variety of control and co-ordination systems and, at organisational level, they continued to find budgets useful.

Budgets can be important for planning and co-ordination and they may be used to set resource limits for functions such as services and R&D. Budgeting may be combined with output measures, such as margin or revenue targets for market-based areas or divisions, and standard costing where repetitive processes could be specified.

Different business functions require different controls and, if there are interrelationships among functions, a budget may be important for co-ordination. Also, budgetary control over the input of resources may be desirable for some functions.

Our research shows that budgets are still a key part of the management accountant's armoury and that, within business units, they are used with other techniques to co-ordinate, control and motivate. Different functions need different control systems and a mechanism to co-ordinate them. Our case studies show how combinations of process, output and input controls, budgets and transfer pricing can be designed to accommodate a firm's aims and strategies. See the panel, right, for some tentative propositions that have emerged.

Our finding that many business units use budgeting systems seems to counter Hope's and Fraser's recommendations that companies should abandon budgets. But, while our research focused on business units, Hope and Fraser concentrated on relations between the corporate centre and the business units. A large company could abandon budgets for controlling business units while permitting these business units to use budgets. Additionally, the beyond budgeting literature has emphasised Svenska Handelsbanken, but systems for pooled organisations such as banks may not be appropriate for other organisations, particularly those with significant local complexity.

Lastly, we have been alert to the need for differing control systems for production, marketing and service functions, and for a carefully designed structure so that the management emphasises metrics that fit business unit strategies. We expect to make prescriptive recommendations in these areas based on our findings and on extensive organisational control literature. **FM**

References

- 1 David Dugdale, T Colwyn Jones and Stephen Green, *Contemporary Management Accounting Practices in UK Manufacturing*, CIMA Publishing/Elsevier, 2005.
- 2 Robin Hope and Jeremy Fraser, "Who needs budgets?", *Harvard Business Review*, February 2003.

David Dugdale is professor of management accounting and **Stephen Lyne** is head of the School of Economics, Finance and Accounting at the University of Bristol. They thank the CIMA Research Foundation for its support.

STRUCTURE AND CONTROL: LYNE'S AND DUGDALE'S PROPOSITIONS

1 Output controls alone can be effective for independent business units. If units are autonomous, then output controls may be the most effective way to manage them. Their managers are likely to be highly motivated and to feel ownership of operations and results.

2 Budgets may not be necessary to control independent, autonomous units. If the units are truly independent – so that, for example, other group companies do not have to buy their goods – then there may be little need for co-ordinating mechanisms such as a detailed corporate budget.

3 Output controls can be important even within business units. If market-based units are identified within business units, then output controls can be the main method of controlling these units. If contribution, margin and profit targets are set, managers can be given freedom to pursue them.

4 Budgets are likely to be needed for co-ordination within business units. Complexity within business units is likely to mean that budgets are used to co-ordinate many differentiated functions. Market-based, output-controlled operations in business units, although not unduly constrained by budgets, are likely to be part of a budget process that co-ordinates their activities with other parts of the organisation.

5 Process controls may be important within business units. If a business unit produces standard products or uses standard processes, then that element is likely to be subject to process controls such as standard costs or operating procedures. Direct supervision might be important and this part of the organisation is more likely to be hierarchical.

6 Budgets may be part of the standard-setting process. Budgets can help to establish the availability of resources and standard processes. But control is achieved by measuring the efficiency of operations, comparing output achieved with standard allowances needed to achieve it.

7 Budgetary control over resources may be important for some functions. Certain aspects of functions, such as research, finance, HR and IT, cannot easily be controlled through efficiency calculations or output measures. In these circumstances budgets help to control resources. Managers need special authorisation if they wish to exceed their budget.

Copyright of *Financial Management* (14719185) is the property of Caspian Publishing and its content may not be copied or emailed to multiple sites or posted to a listserv without the copyright holder's express written permission. However, users may print, download, or email articles for individual use.