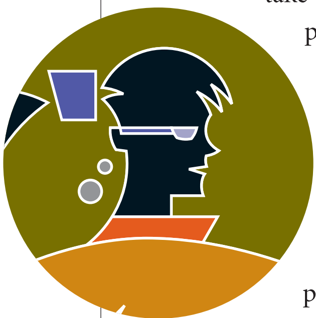
BEYOND BUDGETING OR BETTER BUDGETING?

IMA members express their views.

By Theresa Libby, CA, and
R. Murray Lindsay, CMA

Most organizations recognize budgets as a key element in their management control systems, but the *usefulness* of budgets has generated much recent discussion and debate. Though budgets are useful for coordination, communication, and performance evaluation, many people consider them the cause of gaming and earnings manipulation by managers, time-consuming and costly to develop, and a barrier to change. Indeed, even Charles Horngren, whose popular textbooks have promoted traditional budgeting for more than 40 years, admits that "numerous managers are extremely unhappy about budgeting." In their book *Beyond Budgeting: How Managers Can Break Free from the Annual Performance Trap*, Jeremy Hope and Robin Fraser argue that traditional budgeting is counterproductive in today's fast-paced and highly competitive environment. Instead of tinkering with current budgeting systems, managers would be better off abandoning budgeting altogether—that is, companies should move beyond budgeting.

Hope and Fraser propose a new management model to take the place of budgeting for control purposes. This new model is based on employee empowerment and alternative methods of performance management. In their view, traditional budgeting with its emphasis on the fixed performance contract—where targets are set at the beginning of the period and results are evaluated relative to this static plan—won't support the types of extreme decentralization and employee empowerment initiatives that are required for firms to be competitive today. The clarity and cogency of Hope and Fraser's argument suggest that it deserves serious consideration. Moreover, the authors have marshaled some impressive case studies from which they have derived their new model of control.



But even casual empiricism suggests that the budget remains an important part of many organizations' control systems, particularly in North America. While budgeting practices may require improvement, for many firms budgets are deeply ingrained in the "way we do things around here" and may be the only means of communication, coordination, and control across the organization. That's why it may be difficult for managers to give up budgets. There are also several well-known examples of extremely successful U.S. companies whose budgets lie at the heart of their management control system. For example, Johnson & Johnson relies extensively on budgeting systems and is perennially ranked as one of the best-managed firms in *Fortune*'s annual survey. Emerson Electric is another such company whose former CEO, Charles Knight, extols the value of the company's budgeting system in a recent book called *Performance without Compromise*.

To capture the pulse of U.S. managers in terms of their views of budgeting, we surveyed IMA members in the spring of 2005. To be included, the IMA member must have held a senior management position in a for-profit organization in the U.S. that employs at least 100 people and must have had some influence over budgeting. We e-mailed those selected and invited them to complete the survey by logging in to a password-protected survey website. In particular, we tried to find answers to the following questions:

- Are there widespread plans for firms in the U.S. to abandon budgeting? In other words, are budgets dispensable?
- Do managers generally agree with the major criticisms that have been levelled at budgeting?
- Do managers view these problems as having more to do with how budgets are used than with budgeting itself? In other words, is budgeting inherently flawed?
- Do managers believe budgets are adding value in their organizations?

A total of 212 IMA members completed surveys. Approximately half worked for manufacturing organizations and the other half for service companies, such as financial services, consulting, real estate, etc. Respondents had been in their current position an average of about five years and were employed on average about eight years with their company. Average total revenues for the business units surveyed was estimated to be between \$50 million to \$100 million with total revenues ranging from less than \$1 million (four responding organizations) to total revenues greater than \$5 billion (nine responding organizations).

We'll now share the results.

ARE BUDGETS DISPENSABLE?

Respondents indicated their degree of agreement with the statement "Budgets are indispensable; we could not manage without them." With 1 indicating strongly disagree and 6 strongly agree, the average response was 4.22, indicating that managers tended to agree at least somewhat with this statement. In fact, Figure 1 reveals that fully 50% agreed or strongly agreed that budgets are indispensable

Figure 1: "Budgets are indispensable; we could not manage without them."

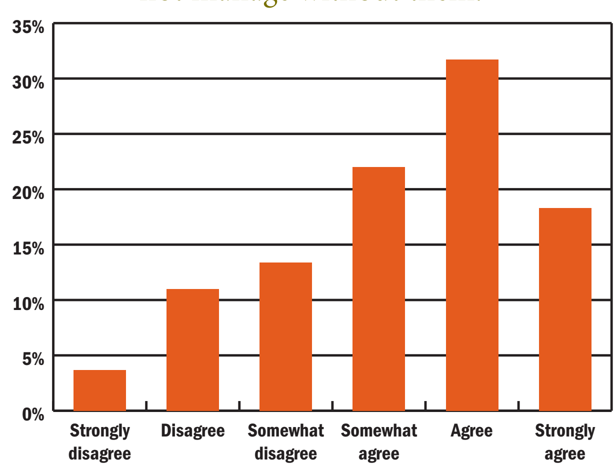
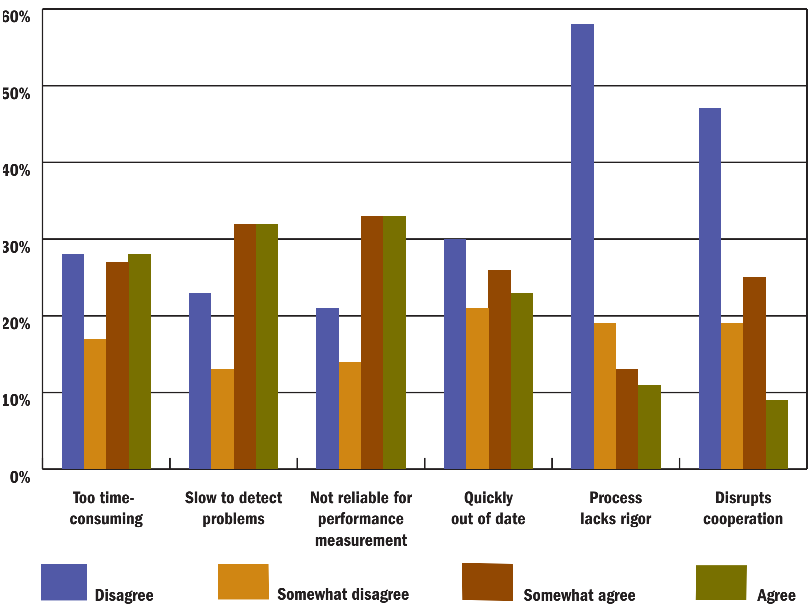


Figure 2: Criticisms of Budgeting



and companies couldn't manage without them. Only 15% disagreed with this statement. This statistic supports the view that budgeting won't become an endangered species anytime soon, but there are a minority of firms who may be receptive to the beyond budgeting message.

CRITICISMS OF BUDGETS

Next we examined six key criticisms of budgets as determined by a review of the budgeting literature. Figure 2 presents the distribution of responses. Overall, 28% of respondents disagree that budgeting is time-consuming and costly, while an equal proportion agrees with this statement. On average, the complete budgeting cycle took 10.3 weeks to complete in the responding organizations, with each individual manager spending about two to three weeks preparing the part of the budget under his or her control. This time frame appears to be much less than the 10 to 15 weeks alluded to by Hope and Fraser.

In addition, 64% of the respondents agree or somewhat agree that budgets are slow to detect problems, while 51% of the respondents disagree or somewhat disagree that budgets quickly become out of date. Fully 76% of the respondents disagree or somewhat disagree that the budget process lacks rigor and is based on unsupported assumptions, while 47% disagree with the statement that budgeting causes adversarial relations rather than cooperative behavior within companies.

We further explored the concern that budgets may quickly become out of date. About half responded that, once accepted, budgets were fixed and no changes could be made to them. The other half attempted to deal with the need for budgets to be updated by allowing for revisions during the year on an ad hoc basis (25%), on a quarterly or semiannual basis (15%), or on a rolling basis (10%).

Sixty-six percent of the respondents agree or somewhat agree that comparing actual to budget doesn't measure a manager's performance reliably. Despite this concern, on average, responding organizations tended to place moderate to considerable reliance on the budget for performance evaluation and control purposes. To better understand this issue, we examined in more detail the way responding organizations use budgets. In particular, we were interested in whether companies use budgets rigidly in the sense of a fixed performance contract as Hope and Fraser have suggested. To this end, we asked respondents to indicate the degree to which budgets were emphasized in performance evaluation. Overall, 63% indicated budgets were significantly emphasized in evaluations, but 37% indicated they weren't. We then asked respondents from the first subset to select the statement from the following list that best described how managers were evaluated in their organizations. Here are the percentages of respondents who chose each of the following statements:

- Budgets are used rigidly as a performance evaluation standard (15%).
- Noncontrollable variances are backed out before comparing actual to budget (25%).
- Budgets are adjusted for actual values of key contingency variables using a formula established at the beginning of the period (5%).
- Evaluations are based on both meeting the budget standard and performance on other nonfinancial targets (25%).
- Evaluating managers consider performance relative to the budget standard along with other considerations incorporated subjectively into the evaluation (30%).

In summary, it seems that many organizations use budgets as a basis for performance evaluation, but only 15% indicate actual performance is compared rigidly to pre-established budget targets as the only basis for evaluating managers' performance. These results suggest that budgeting may not be used as rigidly in many organizations as the beyond budgeting literature might lead us to believe. Indeed, many organizations incorporate budgetary performance subjectively into the overall performance evaluation of managers.

The final—and perhaps most important—criticism involves budget gaming. Hope and Fraser argue that tying budget targets to compensation contracts encourages managers to game the budgeting system to increase the probability they'll receive positive performance evaluations and, therefore, any related bonus. To investigate this matter, we asked respondents to indicate how frequently they had observed budget games in their organizations over the last two years. In particular, we wondered how often managers:

- Spent money at the end of the budget period to avoid losing it in the next budget period.
- Deferred necessary expenditures (e.g., maintenance, advertising, R&D) to meet current period budget targets.
- Accelerated sales near the end of the reporting period to make the budget.
- Took a "big bath" when budget targets couldn't be attained.
- Negotiated easier targets to help ensure bonuses would be received (i.e., sandbagging).

As Figure 3 indicates, all of these budget games occur at least occasionally in many of the organizations surveyed, but deferring necessary expenditures and sandbagging occur most frequently.

Hope and Fraser are concerned that by tying the achievement of short-term budget targets to managers' compensation contracts, managers may focus on increasing short-term profit to the detriment of long-run performance. When asked whether gaming impaired long-run organizational performance, 61% indicated either not at all or a little, 22% indicated long-run performance was moderately impaired, and 17% indicated it was impaired considerably or to a very high extent. Thus, 39% of companies who reported gaming behaviors indicate they have at least a moderate impact on the company's long-run performance. This is a potentially worrisome finding.

Overall, this data clearly indicates that budgeting has problems and that many criticisms are valid, but these problems are far from universal in their application to all companies. These results suggest that further analysis is needed to determine the specific conditions giving rise to these problems.

IS BUDGETING INHERENTLY FLAWED?

While no one would deny that budgets and budgeting have their problems, there's no consensus in the literature as to whether companies can overcome these problems. To investigate this matter, we asked respondents to indicate whether they agreed that "The problems with budgeting are more to do with how they are used and some of the roles they are asked to play; budgets have potential to be extremely useful if used appropriately." The average level of agreement with this statement was 5 on a scale of 6. It's interesting to note that 96.3% of respondents agreed "at least somewhat" with the statement.

ARE BUDGETS ADDING VALUE?

The previous analysis indicates the majority of organizations will continue to use budgets. Given this observation, we wondered to what degree respondents viewed budgeting processes as adding value, so we asked respondents to assign an overall grade to their budgeting system using a scale of 0 (disaster) through 100 (excellent), with scores below 50 indicating a failing grade. In assigning this grade, respondents were supposed to take into account the amount of management time spent on the budgeting process, the budget system's effectiveness in assisting the business unit to achieve its goals, and any dysfunctional behaviors that the budgeting system might

Figure 3: Budget Gaming

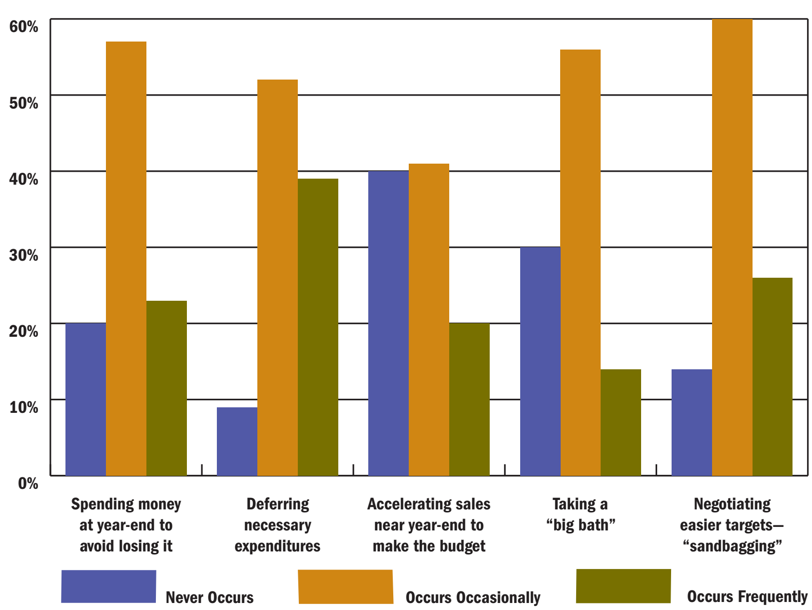
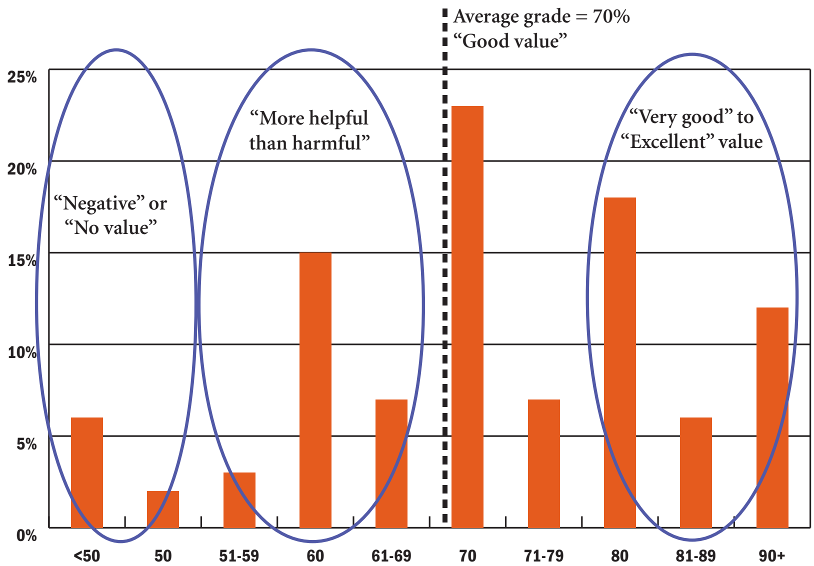


Figure 4: Are Budgeting Systems Adding Value?



cause. The average grade assigned to the budgeting system was 70 out of 100, indicating that, on average, good value was being obtained from the budget—even after considering the time and cost of budgeting and the dysfunctional behavior it can motivate. As Figure 4 shows, 66% assigned their budgeting system a grade of 70 or above, indicating they received good to excellent value from it. Of the remaining respondents, 25% indicated that the budget was more helpful than harmful, and only 8% indicated they received no value or negative value from their budgeting systems.

WE STILL WANT BUDGETS

Our results indicate three main things. First, while many criticisms levied against budgets are valid, they're far from universal. Second, respondents indicate overwhelmingly that they couldn't manage without budgets. To them, budgets are indispensable. Third, instead of going beyond budgeting, they've chosen to improve the budgeting process and carry on. That is, budgeting appears to be a process that's evolving. It's interesting to note that a budgeting forum held in the United Kingdom in 2004, sponsored by the Chartered Institute of Management Accountants and Institute of Chartered Accountants in England and Wales, came to a similar conclusion (see http://www.icaew.com/index.cfm?route=117649).

Do these findings invalidate the management model espoused by the beyond budgeting movement? The answer is clearly, no. The data does support the view that problems exist with the budgeting systems in some companies, especially with respect to budget gaming. But the data also suggests that claims that budgets are fundamentally flawed are probably overstated. Although an accurate assessment of this conclusion would require a rigorously designed study comparing performance data of firms using budgets for control with those following the beyond budgeting model, the data reported here suggests that such a blanket statement appears unwarranted.

Organizations continue to use budgets for control purposes, and they derive considerable value from their use. It would seem more fruitful to determine when traditional budgeting loses its effectiveness and whether the way a budget is used impacts the value that organizations experience. For example, the results indicating that budgetary information is used in a variety of different ways for performance evaluation across firms suggests the fixed performance contract argument of the beyond budgeting movement is far from universal in its application. It's entirely possible, as the Johnson & Johnson and Emerson Electric examples indicate, that both the beyond budgeting and budgeting models can be highly effective if designed appropriately, regardless of the specific conditions faced. Alternatively, one approach may have a greater propensity of success than the other under certain conditions. Nevertheless, while many of us might be skeptical of abandoning budgeting, the beyond budgeting movement has sparked deeper thinking by us all about the usefulness of budgeting for purposes of management control. ■

The authors would like to thank the Social Sciences and Humanities Research Council of Canada and the Institute of Management Accountants (IMA®) for support of this project. In addition, we appreciate the help of IMA members who participated in our survey.

Theresa Libby, CA, Ph.D., is an associate professor of management accounting and control in the School of Business and Economics at Wilfrid Laurier University in Waterloo, Ontario, Canada. You can reach Theresa at tlibby@wlu.ca.

R. Murray Lindsay, CMA, Ph.D., is professor of accounting and dean of the faculty of management at the University of Lethbridge in Lethbridge, Alberta, Canada. You can reach Murray at m.lindsay@uleth.ca.