CHAPTER 9 - Implementation issues

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9.3 Crystallizing the strategic plan into an operational budget

Active reading. Note the different types of budget and where they are appropriate. Also, note the role that accountants play in the preparation of budgets and their use via budgetary control.

The use of operational budgets is a standard accounting tool that is used in strategy implementation (Horngren et al., 2000). There have been numerous citings of the criticism of the budgeting process over the years (see, for example, Otley, 1994; Hope and Fraser, 2000; Hansen et al., 2003; Dugdale and Lyne, 2006; Libby and Lindsay, 2010). Despite the criticisms, the multiple facets of budgeting and diversity of purpose that budgets provide can go some way to explaining why their use is still evident in many organizations (Hansen and Van der Stede, 2004).

Budgets provide a mechanism for crystallizing the strategic plan, or at for the least the first year. The operational budget is expressed in both nonfinancial and financial terms, although the ultimate budgeted income statement (profit and loss account) and balance sheet capture the impact of the strategy implementation on the overall short term financial performance of the organization.

The budget preparation process enables the strategic intent and objectives to be communicated to the participants in its detailed preparation. It provides a means of coordinating the activities of the functions and subsequently provides the mechanism for control. Budget centers provide the framework for responsibility accounting, which can be used for motivational purposes, target setting, and subsequent performance evaluation. Budgets also provide a basis for resource planning, such as capacity planning, materials, and labor.

The accountant is heavily involved in the preparation of the budget, and, in small to medium-sized organizations, is often the primary coordinator of the functional budgets. The accountant will liaise with functional managers to ensure that budgets are prepared following any corporate guidelines, such as inflation rates, or salary rises to be applied, and that it is completed within the budget timetable. In larger organizations, there may be a budget committee involving all functional heads, that sets the schedule and guidelines. The typical budget period is the normal accounting year (twelve months or thirteen four weekly periods).

Due to the annual timeframe applied, it often becomes seen as a yearly chore of managers to prepare the budget. Some of the criticism of budgets, therefore, arises from the process of their preparation. They are said to be time-consuming. They may constrain managers and thus act to stifle innovation and initiatives. They can cause dysfunctional behavior in their preparation, such as gaming strategies. For example, artificially inflating costs and being conservative on revenues to generate easy targets, adopting the mentality of spending it or lose it next year, or not taking ownership of the budget. However, there are ways to overcome some of the criticism that will be discussed later in this section.

9.3.1 Starting point of the traditional budget process

The starting point of the traditional budgeting process is the sales budget. In this instance, sales would be referred to as the principal budget factor, although other factors, such as production capacity, maybe the constraint around which the annual budget is built. In this case, a strategic option being pursued would be the expansion of production capacity, assuming the demand warranted such a choice. At the same time, the operating budget would be set to assume that all of the existing capacity can be sold until any additional capacity is made available.

The sales forecast usually sets the basis for production, which in turn considers any planned increase or decrease in inventory levels. The forecast represents an estimate of what is likely to occur in the future. Statistical techniques can be employed, such as regression and time series analysis to help identify trends. Time series is useful for identifying seasonal or cyclical variations. The environmental analysis will also be invaluable in helping to identify factors that could affect market demand and, subsequently, the organization's level of demand. Elements from the PESTEL (political, economic, sociocultural, technological, environmental, and legal) and Porter's five forces analysis may influence future demand. Issues such as pricing strategy and the degree of marketing support that can be provided will also impact on sales levels.

The resource audit from the internal analysis will also indicate any constraints on the organization in terms of fulfilling demand. The effect of any planned new strategic options needs to be built into the budget so that the budget encapsulates the first year of the strategic plan. This setting down of the first year in a fixed plan leads to another criticism that in fast-changing environments, the budget can quickly become out of date.

The use of sensitivity analysis and computer modeling can be a useful aid in settling on the overall level of demand as it sets the target against which performance is measured during the year, and it needs to be challenging yet achievable. For that reason, all functional managers must have an input into the budgeting process against which their performance is measured so that they buy-in to the targets. Budgets that are set centrally and passed down to managers are doomed to failure due to a potential lack of commitment from the managers that implement the strategy at ground level.

9.3.2 The budget process

Once the principal budget factor has been agreed upon and the level of operational activity set, the other functional budgets can be established. In the case of the production budget, this can be worked backward from the number of items to be produced, given the planned levels of inventory, to determine the purchase of raw materials and components, and ensure that labor requirements are available. Systems such as material requirements planning (MRP) and enterprise resource planning (ERP) systems can aid this process.

The service functions can then be determined, such as maintenance, which might include a planned changeover, setups, and so on. All functions within the organization prepare a budget to support the planned level of demand. Any new capital expenditure that is required will be identified on a capital expenditure budget. All the functional and capital expenditure budgets are then coordinated and combined to produce the overall cash budget, profit and loss, and balance sheet for the financial year.

Agreeing on the budget is inevitably an iterative process as the first pass may not produce the desired profit levels. Profit could be increased in broad terms by increasing sales revenue or reducing costs. There is an element of negotiation and target setting within the budgeting process so that the end budget becomes a target for achievement. Monitoring is then traditionally done against the budget with reporting explaining any deviations from the budget and informing actions to correct any undesirable deviations. Or, indeed, to increase and continue any favorable variations.

The format of the budget and planning relationships is shown in figure 9.1

Figure 9.1 Budgeted profit and loss account elements

The projected budgeted balance sheet is calculated, taking into account any capital expenditure required on new investments, such as plant and equipment. The accounts receivable and accounts payable from sales and expenses are calculated, together with any changes in inventory levels to calculate the working capital and cash budget.

The master budget then consists of the budgeted profit and loss account, the balance sheet, and cash flow statement, as indicated in figure 9.2.

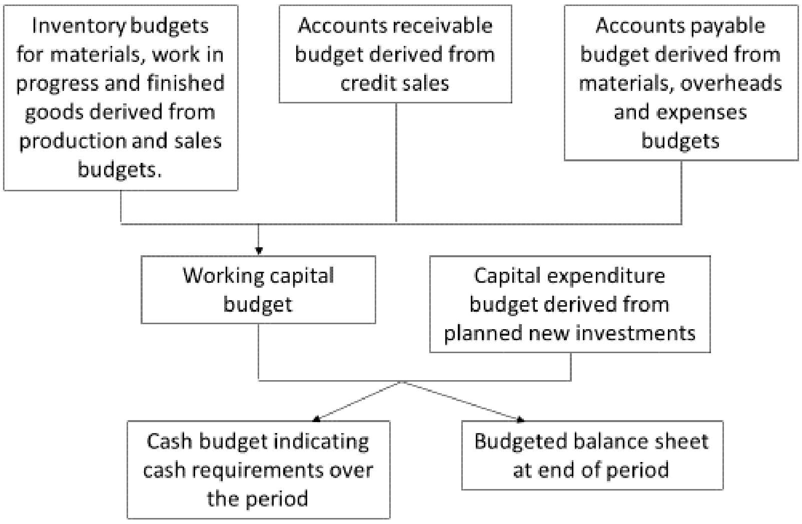

Figure 9.2 Cash budget and budgeted balance sheet

9.3.3 Types of budget process

There are several types of budget processes that have been adopted for various circumstances over the years.

Incremental budgeting

Incremental budgeting has been commonly used and is one way of speeding up the process. The last year's figures are used as a base and increased or decreased depending on levels of activity compared to the previous year. Some accounting software has a facility to populate the budget fields for next year with the current year (or last year's) actuals plus or minus a percentage. This approach is dangerous as there is no guarantee that next year will be the same as last year. Plus, it almost inevitably means that managers will not pay enough attention to the budget process as a means of planning the next year in relation to the strategy. Of course, there may be situations in some businesses where it is part of a growing market, with low levels of competition and a stable environment where this is appropriate. Still, it is not a method that encourages buy-in to the strategy of the organization from front line managers.

Zero-based budgeting

The zero-based budgeting (ZBB) approach is almost the opposite of the incremental budget in that the budget is prepared from scratch. Once the level of activity is decided, managers determine the level of resources required to achieve the objectives. The advantage is that it encourages managers to question the way operations are performed. They can consider whether the activity needs to be carried out, and what would be the consequences if it is not carried out? Are there alternative ways of providing the function? It has the advantage that managers can consider the most appropriate and best way of achieving the objective.

For example, suppose the maintenance of the production line can be carried out in-house by employing two full-time employees or using an external organization to provide maintenance under an outsourcing contract. These are known as mutually exclusive decisions as it would not be appropriate to do both, so the manager must decide as to which is the best. It is not just a financial decision but encourages managers to consider the strategic implication of outsourcing this function. It also has the added advantage that managers are fully involved in the process and promotes efficient allocation of resources, but it comes with added effort in the preparation. The principle of ZBB, however, can provide added benefits to specific functions, such as maintenance or service level departments. Still, the production budget may be prepared simply based on the number of units required to be produced.

Activity-based budgeting

As the title suggests, the budget is based on activity levels. It is designed to be used with ABC costing systems in which the organization has access to activity level data.

Program planning and budgeting system

In an organization where large projects are undertaken that span more than one year each program or project may have its own budget that was prepared as part of the project proposal. For example, a consulting engineering firm that designs and oversees the construction of large civil engineering projects, or construction companies involved in large projects that span several years, will have probably won most of its work under a competitive tender. The tender process will have involved preparing a detailed budget plan for the whole of the project. In these cases, it makes sense to use the project budgets as the basis for an annual budget to ensure that resources are available to undertake the projects currently underway, plus new projects that it hopes to win and commence during the year. In organizations that provide project services, there may well be a base level of resources, for example, a given level of staff that is supplemented, in the short term, by contract staff as new contracts are won.

Program planning is also useful for the public sector and not-for-profit organizations in that they can focus on programs and activities that generate the most beneficial results. In a similar way to zero-based budgeting, there may be alternative programs that the organization can undertake to improve the situation for its beneficiaries. These programs often span more than one financial year, and it is not possible to determine, for example, a specific number of victims, crimes, patients, or sufferers that can be helped. Still, these organizations are often judged on an annual basis. Preparing and reporting against a budget based on a program of activities can be a useful way of planning and reporting the costs and benefits of the various alternative programs.

Rolling budgets

Rolling budgets are budgets that are continuously updated by adding a further period (for example a month, or a quarter) and deducting the earliest period. The use of rolling budgets is useful in times of uncertainly when it is difficult to prepare accurate forecasts. At the outset, an annual budget is made, and then at the end of each reporting period, the plan/budget is extended so that it always covers a total of one year. This process does initially involve more effort, but it can become part of the regular activity of the reporting and evaluation phase. Managers are encouraged to consider changes to the environment continually and to incorporate these into future plans.

Senior managers can provide oversight to ensure that the organization is always moving in the right direction, and the strategic intent does not get lost in the detail. It does, however, run the risk of managers not paying enough attention to updating the rolling budget as they would if it were an annual activity. There is a danger that managers merely extend a trend into the next accounting period without much thought. Whereas a yearly review might encourage a focused consideration of the budget, simply because of the spotlight, the annual activity places on the process.

9.3.4 Budgetary control with the latest estimated forecast or trend

The use of an estimated forecast or trend column on monitoring reports can be used to allow managers to take account of changes in the environment. Once developed and agreed, the monitoring of budgets would include the reporting of a trend or estimated forecast. This can be achieved by reporting the actual period results against budget/plan, together with the year to date and the future estimated forecast, as illustrated in the headings shown in Table 9.1.

Table 9.1 Typical headings for reporting actual results with the latest estimated forecast

Description Income and expense headings	This period		Year to date		Total year	
	Actual	Plan	Actual	Plan	Latest estimated forecast	Plan

The idea behind the representation in Table 9.1 is that the latest estimated forecast of the total year allows business units to express what they think they will be able to achieve, given the changes in the environment and resource position, since the original plan was developed. The reporting of the current year ties into the need to produce financial accounts for publication and communication to shareholders. It not only provides an early warning of any potential gap but also indicates that business unit managers need to be aware of their business environment and the progress toward achieving strategic objectives. The use of rolling budgets every quarter can also assist in this process, as the process of forecasting becomes part of the regular job. However, there is a danger that managers fall into the trap of merely extending the actual to-date and extrapolating a trend line to indicate the future when the idea is that managers proactively manage the future, not merely assume that current trends continue.

Learning activity. The use of budgets has received their fair share of criticism over the years, such as time-consuming, resource-intensive, lack of buy-in by managers, inflexible, stifle innovation, and speed of response. There are, however, benefits in that they provide a means of planning, communication of objectives, coordination of activities, and allocating resources. Before reading the next section on beyond budgets, think about the following questions.

Do you think that the benefits outweigh the criticisms? Could the drawbacks of preparing budgets be overcome? Would you be in favor of using budgetary control as a means of monitoring progress towards achieving objectives?

9.4 Beyond budgeting

Active reading. Note the criticisms of traditional budgets that beyond budgeting seeks to address and the principles of beyond budgeting.

Due to the criticisms leveled at the budgeting process, mainly time-consuming, resource-intensive, restricting innovation and prompt action, and the potential for dysfunctional behavior by the participants (Hansen et al., 2003)(Otley, 1994), several authors proposed alternatives, notably Hope and Fraser (2000). The system promoted by Hope and Fraser is known as "Beyond Budgeting" with organizations and interested parties promoting its use through the Beyond Budgeting Round Table (https://bbrt.org/.). The beyond budgeting idea challenges the use of the traditional budget. Traditional budgets are frequently produced within the comfort zone of the managers, whereas beyond budgeting encourages the use of stretch targets. It moves from stability to continuous challenge at work, from a routine-based performance to a nonroutine-based performance.

The principle of continuous improvement measured against challenging targets in comparison to competition or past performance is a crucial aspect of beyond budgeting. It is about moving beyond the comfort zone of normal operations (Hope and Fraser, 2000; Bourmistrov and Kaarbøe, 2013). The system requires a move towards decentralization, or as Hope and Fraser suggest, it is not so much decentralization as autonomy within boundaries. It is more like managers are running their own business (Hope and Fraser, 1999). It has been found that this attracts certain types of employees and encourages high levels of performance. This change in mindset can, however, have an adverse effect in that faced with challenging targets, instead of treating it as a learning environment and relishing the challenge, managers may move to panic and experience high anxiety levels, discomfort and lower performance (White, 2009). Managers need training and support when moving towards beyond budgeting.

9.4.1 Principles of beyond budgeting

The beyond budgeting system, as put forward by Hope and Fraser (2000), sets out several principles.

Governing through shared values and clear boundaries

Governing through shared values and clear boundaries require senior managers to set the strategic direction of the organization and to communicate this to all employees. Oversight is then provided by the senior managers to ensure that decisions made by managers do not force the organization away from the overall strategic intent.

Creating as many autonomous profit centers as possible

Creating as many autonomous profit centers as possible provides managers with the freedom to feel that they are in charge of their bottom line and running their own business. Indeed, all employees appear to be given considerable latitude in how they reach their goals (Østergren and Stensaker, 2011).

Coordinating the organization through market forces

Coordinating the organization through market forces encourages an external view of the organization rather than an internal perspective. It promotes a customer focus to the organization, and one based on adding value. The external view encourages managers to look for changes in the environment and to monitor competitor actions.

Giving managers the freedom to act and the responsibility to deliver results

Managers have the autonomy to respond to changes in the environment, competitor actions, and to make improvements to meet the challenging targets. Performance, however, should not be so much about beating the target as making continuous improvements.

Providing front-line managers with fast and open information networks

If managers are to respond to changes in the environment and make continuous improvements, they need access to timely information, both internal and external. It is the responsibility of the organization to provide systems that can provide managers with information to manage effectively.

Giving managers the training and tools to think and act decisively

It is recognized that managers will require support in any move towards beyond budgeting as it is a change of mindset and a different way of working. A coaching style of management provoking empowered, and accountable employees are the core to the beyond budgeting approach (Bogsnes, 2009).

9.4.2 Features of beyond budgeting

Setting targets relative to benchmarks

Features of a beyond budgeting system include setting targets relative to benchmarks, such as industry standards, or competitors, whether internal or external. It is about striving to be the best in the sector. Beyond budgeting requires the use of effective anticipatory management systems, such as rolling forecasts that allow managers to adjust projections to take account of changing environmental conditions. The managers are not bound to an original target but are allowed flexibility and encouraged to act and adapt to changes in the market. This flexibility extends to the strategy process, which is devolved to the business units and teams, with oversight from senior managers.

Keeping performance measurement in step with strategy

Melnyk et al. (2014) noted that when environmental changes take place, there is a need to update the strategy that then feeds through into a change in the performance measurement and management (PMM) system. In many organizations, the PMM system is not updated, or there is a delay in making any changes required. They suggest that the strategy and the PMM system need to be co-created so that it better reflects the business environment and strategy being developed. Beyond budgeting will enable the PMM system to be updated as the strategy is updated due to the flexibility of the systems and that strategy and targets (performance measures) are reviewed regularly.

Encourage flexibility

Becker et al. (2016) noted that in times of crisis, the users of traditional budgeting systems tended to focus on the planning and resource allocation aspects of the process, and the performance evaluation was less of a priority. The advocates of beyond budgeting would suggest that the organization adopting the beyond budgeting principles should enable the organization to respond to a crisis more effectively than the traditional fixed annual budget approach, simply because the beyond budgeting encourages flexibility, the ability to respond, and externality of the stretch targets.

Big picture approach to investment

The investment management process needs to be flexible and able to respond as managers are encouraged to be flexible and adaptable in their approach to environmental changes. They are encouraged to look at the big picture and to focus on possibilities and flexibility (Østergren and Stensaker, 2011). Using an approach such as real options would provide a means of providing managers with an evaluation of the potential investment options, including exit routes.

Reporting to managers

The performance reporting needs to be aimed at front-line managers with senior managers informed on an exception basis. The use of interactive controls, belief, and boundary systems (Simons, 1994) are more appropriate to provide managers with the degree of autonomy that they need. The rewards are based on relative performance, and therefore managers need to feel that they are in control.

Measure relative performance against a balanced scorecard

The idea of relative performance is that performance is measured against a benchmark that encourages improvement. The measures should be few, simple and transparent, which aligns performance and rewards to the strategic goals. A system such as the balanced scorecard is ideal as the use of objectives, targets, and initiatives provide the basis for continuous improvement. The idea of interlocking scorecards (section 10.3) also provides the coordination required between business units.

System of rewards

Where possible, it is desirable under beyond budgeting to reward teams. In this context, a team is any group that represents an interdependent value delivery network (Hope and Fraser, 2003). This idea has links to lean systems, and lean accounting (section 6.7) in that value streams may constitute the formation of a team for rewards and continuous improvement. It has been suggested that rewarding teams enables the slackers to benefit, but under systems where peer pressure encourages performance, slackers are soon found out (Hope and Fraser, 2003). The beyond budgeting system, despite the competitive aspect (internally between teams), encourages the sharing of ideas. For example, if a team finds a good way of solving a problem or improving performance, they are encouraged to share with other teams.

Learning activity. Do you think that the principles of beyond budgeting adequately address the criticisms and provide an alternative to the more traditional approaches to budgeting of monitoring performance and aiding the achievement of strategic objectives? Which system would you personally prefer to work under, and why?