After studying this chapter, you will be able to:

- Discuss the concept of the Budget as a Control System and the use of Responsibility Accounting
- Explain how Budgetary Systems fit within the Performance Hierarchy
- Select and Explain appropriate budgetary systems for an organisation, including Top-Down, Bottom-up, Feedback and Feed-forward Control
- Explain the Beyond Budgeting Model, including the benefits and problems that may be faced if it is adopted in an organisation
- Discuss the issues surrounding setting the difficulty level for a Budget
- Explain the benefits and difficulties of the Participation of Employees in the Negotiation of Targets
- Explain how Budget Systems can deal with uncertainty in the environment
CHAPTER OVERVIEW

Budgetary Control

Limitations of Traditional Budgets

Control Schemes
- Feedback Control
- Feedforward Control

Behavioural Aspects of Budgetary Control
- Effect of the Budget Difficulty on Performance
- Participation in Budget Setting Process
- Use of Accounting Information in Performance Evaluation

Beyond Budgeting
- Characteristics
- Suitability
- Benefits
- Principles for Adaptive Performance Management
- Implementation of Beyond Budgeting
- Traditional vs. Beyond Budgeting

BUDGETARY CONTROL

Budgetary Control is “Systematic control of an organization's operations through establishment of standards and targets regarding income and expenditure, and a continuous monitoring and adjustment of performance against them.”

Brown and Howard defines Budgetary Control is "a system of controlling costs which includes the preparation of budgets, co-ordinating the departments and establishing responsibilities, comparing actual performance with the budgeted and acting upon results to achieve maximum profitability."

Budget is an estimation of revenues and expenses over a specified future period of time which needs to be compiled and re-evaluated on a periodic basis based on the needs of the organisation. Budgetary Control is the process by which budgets are prepared for the future period and are compared with the actual performance for finding out variances, if any. In other words, Budgetary Control is a process with the help of which, managers set financial and performance goals, compare the actual results with the budgets, and adjust performance, as it is needed.

Atrill and McLaney identify a number of characteristics that are common to businesses with effective budgetary control:
Prerequisites of Effective Budgetary Control

- A serious attitude to the system is required
- Clear demarcation between areas of managerial responsibility
- Reasonable budget targets
- Established data collection, analysis and reporting techniques
- Reports aimed at individual managers, rather than general
- Fairly short reporting periods, typically a month
- Timely variance reports
- Action being taken to get operations back under control if they are shown to be out of control

Source: Accounting: An Introduction, 6/E, By Peter Atrill, Eddie McLaney, David Harvey
FEEDBACK AND FEED-FORWARD CONTROL

Feedback and Feed-forward are two types of control schemes for systems that react automatically to changing environmental dynamics. Each utilizes sensors to measure important factors and a set of rules to react to changes in those factors. Feedback and Feedforward Controls may coexist in the same system, but the two designs function in very different ways.

Feedback Control

Feedback as the name suggests is a reaction after an action has taken place. So, there has to be an error if we want to take corrective actions.

According to the CIMA’s Official Terminology, It is defined as: ‘Measurement of differences between planned outputs and actual outputs achieved, and the modification of subsequent action and/or plans to achieve future required results. Feedback control is an integral part of budgetary control and standard costing systems.’

A feedback system would simply compare the actual historical results with the budgeted results.
Types of Feedback

<table>
<thead>
<tr>
<th>Feedback</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Primary</strong></td>
<td>Could be reported to line management in the form of control reports, comparing actual and budgeted results. &lt;br&gt; If the variances are small or can be corrected easily then the information may not be feedback to anyone higher in the organisation.</td>
</tr>
<tr>
<td><strong>Secondary</strong></td>
<td>Where feedback is sent to a higher level in an organisation and can lead to a plan being reviewed and possibly changed. &lt;br&gt; For example, the revision of a budget after large variances were discovered due to price changes over time.</td>
</tr>
<tr>
<td><strong>Negative</strong></td>
<td>Feedback taken to reverse a deviation from standard. &lt;br&gt; This could be by amending the inputs or process so that the system reverts to a steady state. &lt;br&gt; For example, a machine may need to be reset over time to its original settings.</td>
</tr>
<tr>
<td><strong>Positive</strong></td>
<td>Taken to reinforce a deviation from standard. &lt;br&gt; The inputs or process would not be altered.</td>
</tr>
</tbody>
</table>
Control Reports

Control reports are feedback devices, but they are only part of the feedback system. A control report does not by itself cause a change in performance. A change results only when managers take actions that lead to change. Norton Bedford suggested the following five guidelines for feedback management control reports:

- Feedback report should disclose both accomplishment and responsibility
- Feedback reports should be extracted promptly
- Feedback reports should disclose trends and relationships
- Feedback reports should disclose variations from standards
- Feedback reports should be in standardized format

John C. Camillus suggested six broad approaches to implementing Preventive Management Control:

- Indicator, both leading and early warning
- Policy Directives
- Contingency Plans
- Congruent System Design
- Trend Analysis
- Adaptive Mechanisms

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Limitations

Feedback control system does have some operational limitations. First, it depends heavily on success of the error detection system. Second, there may be a time lag between the error detection, error confirmation, and error revision during which actual results may change again.

Feed-forward Control

In certain cases, we may be able to measure the amount of error before it has actually taken place. We may thus be able to place a control mechanism before the error takes place. Feed-forward Control is one such Controlling system.

According to the CIMA’s Official Terminology, *It is defined as the ‘forecasting of differences between actual and planned outcomes and the implementation of actions before the event, to avoid such differences.’*

A feed-forward control system operates by comparing budgeted results against a forecast. Control action is triggered by differences between budgeted and forecasted results.

Example

Information on Industrial Dispute in a state which was a major supplier of an important raw material would cause smart buyers to buy before prices went up and their own inventory were exhausted (in contrast a pure feedback system would not react until inventory had actually fallen).

Any manager who ignores feed-forward control will contribute to the downfall of a company.

Implementation of Feed-forward Control

Guidelines to be followed before implementation of Feed-forward Control
Limitations

Akira Ishiwkawa observed the following limitations of the feed-forward control system:

- The feed-forward process is an evaluation process and is concerned with the estimates of uncertain future. This problem of uncertainty is likely to limit application of the concept.
- Study of future is not well developed; neither are the tools that have potential for overcoming the problem of uncertainty.²

Case Scenario

Real Petroleum Corporation manufactures lubricant oils for motor vehicles (two wheelers, four wheelers and heavy vehicles). The company offers lubricant oils in various packages ranging from a 100 ml pouch to a 200 litres drum. About 70% of lubricant sales comprise are made in the form of 900 ml ‘cans’. The process of manufacturing and packaging lubricant oils are given below:

- Base oil of required grade is imported from middle east.
- The base oil is blended with additives at the manufacturing plants at specified temperatures to produce lubricant oils.
- The oil is stored for a day to bring the temperature to normal.
- The plant has an automated bottling facility. The operator is required to pre-set the quantity and number of ‘cans’ to be filled in a computerised system. No manual intervention is required thereafter.
- The product is filled in ‘cans’ at the first stage of packaging with 900 ml of product.
- Caps are fixed on the ‘cans’ and sealed at the second stage of packaging.
- The product is weighed at third stage of packaging (a conversion factor is used to cover volume into weight) before the ‘cans’ are packed into a carton.

Any ‘can’ having lesser quantity of oil is removed before the ‘cans’ are packed into the cartons. The ‘cans’ which are short filled cannot be reused. Once the seal is broken, the ‘can’ is of no use. There is no process by which the oil in short filled ‘can’ could be reused. Hence the product is wasted.

The company is considering a proposal to add a component in its packaging unit to avoid losses arising out of quantity issues in packaging. The component will be installed after the first stage of packaging. The component will measure the volume of product and will forward the ‘can’ for capping and sealing only if the quantity in ‘cans’ is correct. In case the ‘can’ does not have required volume of product, the ‘can’ will be topped up with balance product before the capping and sealing process. The company will be able to achieve 0% wastage due to short filling after implementation of new system.

Required

Using the context of control systems, IDENTIFY and EXPLAIN the type of control which is existing in the company and the type of control which is proposed.

Solution

What is Control?

Control is a management function of establishing benchmarks and comparing actual performance against the benchmarks and taking corrective actions. Control is required at all levels of organisation to ensure that the organisation achieves its intended objective. There are two types of control systems - Feedback Control and Feed-forward Control.
Feedback Control

Feedback Control is a control activity that takes place after a process is complete. It is also known as post action control. If any problem is identified after a process is complete, a corrective action is taken to rectify the problem. Feedback control provides information only after the process is complete and sometimes a significant time is lost to take corrective action. Feedback-based systems have the advantage of being simple and easy to implement.

Real Petroleum currently has a feedback control mechanism in place. The actual volume of the product is measured at the end of the packaging process. The current control process is that any 'can' which is short filled is not packed in the carton. This ensures that a lower quantity of product is not supplied into the market. The current control system, however, leads to product losses as identification of short-filled ‘cans’ at the end of process is not useful to the production process. In case, there is a huge variation in the final packaging, the packaging system can be reviewed to ensure that such problems do not acquire in the future.

Feed-forward Control

Feed-forward Control is also referred to as a preventive control. The rationale behind feed-forward control is to foresee potential problems and take corrective action to ensure that the final output is as expected. Feed-forward controls are desirable because they allow management to prevent problems rather than having to cure them later. Feed-forward control are costly to implement as it requires additional investment and resources. These are designed to detect deviation some standard or goal to allow correction to be made before a particular sequence of actions is completed.

The proposed system in Real Petroleum is a Feed-forward control. In this case, any short filling is identified in the packaging process itself and corrective action is taken to ensure that the final packed ‘can’ has proper quantity of product. The new process is beneficial to the company as the wastage arising out of the packaging process can be avoided. The savings must be compared with the cost required to modify the packaging process before finalising on whether the new system should be implemented or not.

BEHAVIOURAL ASPECTS OF BUDGETARY CONTROL

Behavioural aspects elucidate that many of the goals of budgeting are contradictory. On the one side, we want to be able to fairly evaluate the performance of managers. But we also want to motivate managers and therefore, even if managers are not involved in the process, managers may find the budget too challenging and therefore reduce their effort. That in turn would distort any evaluation. The participation of managers in setting targets for themselves tends to improve motivation and performance. If, we want budgets to act as a way of communicating organisational goals. But the budget themselves may distort the goals as they will be very short term, be focused on cost reduction rather than, say, quality aspects, and they will solely focus on financial aspects of the organisation's goals. There is therefore a conflict between aiming to achieve financial control and communicating the organisation's goals.
Moreover, the budget is framed to act as a plan for a manager, section, or division. The manager may therefore pursue this plan at the cost of other critical success factors that emerge in the internal or external environment of the firm. For example, a production manager may continue to use the planned materials mix even if the sales department are indicating that customers would desire a different product design and the purchasing department have accommodated their purchases accordingly. The production manager then has to choose between the plan and interdepartmental coordination.

Many of the conflicts arise due to the human nature of a budgetary control system. Managers do not always follow organizational goals, they do not always think long term, they may be cautious of moving away from the plan etc. This provides a conflict between many of the goals of a budgetary control system which needs to be considered at a strategic level when implementing such a system.

**Budget Slack**

Budget affects the approach and behaviour of managers and used to motivate the managers. Unrealistic demanding targets tend to affect manager's performance adversely. Allowing managers to set their own targets will introduce slack targets. Managers working in an environment where they are expected to meet the budget targets often try to introduce slack into budget. But, where there is more relaxed attitude, or when other factors are considered alongside the analysis of variances, managers are general less inclined to introduce slack. But it can have a detrimental impact on the evaluation of actual performance if managers incorporate 'slack' into the budget in order to make it easier to achieve.

**Effect of the Budget Difficulty on Performance**

Once budgets have been set as performance targets, surely performance will be evaluated. This can be simply a comparison of actual with budgeted performance or alternatively can be a more detailed comparison of actual performance with flexed budget performance, as is found in variance analysis and operating statements. The evaluation step is often one of the most argumentative as it is here that performance is likely to be criticised and employees will be sensitive. There are many potential difficulties:

Hofstede (1968)

- Budgets have no motivational effect unless they are accepted by the managers involved as their own personal targets.
- Up to the point where the budget is no longer accepted, the more demanding the target the better the results achieved.
- Demanding budgets are seen as more relevant than less difficult targets, but negative attitudes result if they are seen as too difficult.
- Acceptance of budgets is facilitated when good upward communication exists. The use of departmental meeting was found helpful in encouraging managers to accept budget targets.
Managers’ reactions to budget targets were found affected both by their own personality and by more general cultural and organizational norms.

The relationship between budget difficulty and the ensuring level of performance can be shown graphically and is illustrated as under:

*The Effect of Budget Difficulty on Performance*

“Budget level that motivates the best level of performance may not be achievable. In contrast, the budget that is expected to be achieved motivates a lower level of performance as managers no longer aspire to meet the budget target.” The balanced scorecard approach of Kaplan and Norton, and the building block approach of Fitzgerald and Norton can be a great help in ensuring that objectives (or targets), or budgets are set for a very wide range of factors, both financial and non-financial.

**Case Scenario**

“It’s frustrating working with Denial. He’s very dominant and expects everything to be done his way. We have done more and better work to get up to budget, and the minute we make it he tightens the budget on us. We can’t work any faster and still maintain quality. We always seem to be interrupting the big jobs for all those small rush orders. The accountants seem to know everything that’s happening in my department, sometimes even before I do. I thought all that budget and accounting stuff was supposed to help, but it just gets me into trouble. I’m trying to put out quality work; they’re trying to save money. This is a dead-end job. I don’t see much of a future here.”

– said Mr. Singh, manager of the machine shop of Global Mfg. Ltd. a UK based Company.

Mr. Singh had just attended the monthly performance evaluation meeting for plant department heads. These meetings had been held on the third Friday of each month since Mr. Denial, MBA from Manchester University, had joined the Indian operations a year earlier. Mr. Singh had just
Mr. Singh had been given the worst evaluation he had ever received in his long career with Global Mfg. Ltd. He was the most respected of the experienced machinists in the company. Old Plant Manager had often stated that the company’s success was due to the high quality of the work of machinists like Mr. Singh. He had been with Global Mfg. Ltd. for many years and was promoted to supervisor of the machine shop when the company expanded and moved to its present location. As supervisor, Mr. Singh stressed the importance of craftsmanship and told his workers that he wanted no careless work coming from his department.

When Mr. Denial became the plant manager, he directed that monthly performance comparisons be made between actual and budgeted costs for each department. The departmental budgets were intended to encourage the supervisors to reduce inefficiencies and to seek cost reduction opportunities. The company controller was instructed to have his staff ‘tighten’ the budget slightly whenever a department attained its budget in a given month; this was done to reinforce the plant supervisor’s desire to reduce costs. Mr. Denial often stressed the importance of continued progress toward attaining the budget; he also made it known that he kept a file of these performance reports for future reference.

**Required**

**IDENTIFY** the problems which appear to exist in budgetary control system and explain how budgetary control system could be revised to improve the effectiveness.

**Solution**

The budgetary control system appears to have several very important shortcomings which reduce its effectiveness and may in fact cause it to interfere with good performance. Some of the shortcomings are explained below.

**Lack of Coordinated Goals:** Mr. Singh had been led to believe high quality output is the goal; it now appears low cost is the goal. He does not know what the goals are and thus cannot make decisions which lead toward reaching the goals.

**Influences of Uncontrollable Factors:** The actual performance relative to budget is greatly influenced by uncontrollable factors i.e. rush orders. Thus, the variance reports serve little purpose for evaluation of performance.

**The Short-Run Perspectives:** The monthly evaluation and the budget tightening on a monthly basis result in a very short-run perspective. This will result in inappropriate decisions.

The improvements in the budgetary control system must correct the deficiencies described above. Accordingly:

- Budgetary control system must more clearly define the company’s objectives.
- Budgetary control system must develop an accounting reporting system which better matches controllable factors with supervisor responsibility and authority.
- Establish budget values for appropriate time periods which do not change monthly simply as a result of a change in the prior month’s performance.

The entire company from top management down must be educated in sound budgetary procedures so that all parties will understand the total process and recognize the benefit to be gained.
Participation in Budget Setting Process

There are two main approaches to budgeting, the top down approach and bottom up approach. Budgets can be prepared centrally and subordinates have little influence on the target setting. This called top down budget or imposed style approach. The benefit of top down approach is that it can be produced quickly and involve less management time than other options. However, there are significant risk of inaccurate budgets being set that are also not acceptable to the subordinate managers.

An alternative to top-down approach is for the subordinate managers to participate in the preparation of their own budgets and then these budgets to be reviewed by senior management. This is called bottom up approach (sometimes referred participative approach).
Many researchers have recommended that the bottom up approach involving participation is a preferable method of preparing a budget. Other studies have suggested that participation is not a solution that will solve all problems. Following table highlights factors that have been suggested in different studies as influencing the *effectiveness of participation*:

<table>
<thead>
<tr>
<th>Study</th>
<th>Factors Influencing the Effectiveness of Participation</th>
<th>Participation is Less Effective and Relevant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vroom (1960)</td>
<td>Personality</td>
<td>With managers who are more highly authoritarian.</td>
</tr>
<tr>
<td>Hopwood (1978)</td>
<td>Work Situation</td>
<td>In a highly programmed and technologically constrained environment.</td>
</tr>
<tr>
<td>Brownell (1981)</td>
<td>Locus of Control</td>
<td>For those individuals who feel they have a low degree of control over their destiny.</td>
</tr>
<tr>
<td>Mia (1989)</td>
<td>Job Difficulty</td>
<td>Where job difficulty is low.</td>
</tr>
<tr>
<td>Bruns and Waterhouse (1975)</td>
<td>Types of Organizational Structure</td>
<td>In a centralized organization.</td>
</tr>
</tbody>
</table>

*Source: Business Planning and Control: Integrating Accounting, Strategy, and People by Bruce Bowhill*

The testimony from the various research proposed that participative styles of management will not necessarily more effective than other styles, and that participative methods should be used with care. Accordingly, it is essential to identify those circumstances where there is testimony that participative methods are effective, rather than to introduce universal application into firms. Participation must be used selectively; but if it is used in the right circumstances, it has an outstanding potential for encouraging the assurance to organisational goals, enlightening attitudes towards budgeting system, and increasing subsequent performance. However, there are some limitations on the positive effects of participation in standard setting and *circumstances where top-down budget setting is preferable*. They are as follows:

- **Where personality characteristics of the participation may limit the benefits of participation**
- **Where participation by itself is not adequate in ensuring commitment to standards and managers can significantly influence the results**
- **Where a process is highly programmable and clear, stable input-output relationships**
- **Where a firm has large number of homogeneous units and operating in a stable environment**
Case Scenario

Established in the year 1997, Excellent Woodcraft Private Limited (EWPL) is one of the distinguished manufacturers and suppliers of an unlimited array of Wooden Furniture Items. Product compilation comprises of Modular Furniture, Workstations, and Cafeteria Furniture. Moreover, it is also engaged in presenting Furniture Services that include Interior Fit Out, Office Interiors and Corporate Interior Designing. Since inception, it has strived to proffer an excellent blend of optimum quality and price, and successfully established the company as the preferred choice of customers in the past years. This is the reason that its products and services are applauded in the industry for its flawlessness.

At EWPL, a world-class infrastructure is set up with different types of latest technology based machines and equipment, which provide great support in hassle-free production and storage of the proffered assortment. Besides the spacious workspace, it has recruited a team of skilled and experienced professionals, who are magnificently trained to understand and meet the diverse client requirements within the committed time period. It aims to attain complete client satisfaction and put in its best efforts to achieve the same by offering outstanding product range & feasible services.

EWPL’s Budgeting Process for Sales

1) Each salesgirl makes a customer-wise listing of sales for the last few years. Based on this information and her knowledge about customer’s requirements, she determines an overall sales goal.

2) The sale manager, W Robert, gathers all this information and modifies it a bit. Particularly, W looks at variance in sales growth and modifies low projections to be in line with the average. He, of course, discusses this correction with the concerned salesgirl. The usual approach is to hold up the other forecasts and attribute lack of sales growth to lower talent.

3) W then meets with J Donald, Managing Director. By this time, J already back out of his sales expectations for next year based on his desired profit. J discusses the overall target with the W. The usual result is a 7% to 10% increase in projected sales, which the W allocates among the salesgirls based on their past performance.

4) Of course, J desires that the W discuss and negotiate any alteration with the sales force. He believes that with appropriate logics, not high but attainable targets for his sales team can be met.

Required

(i) DISCUSS the participative nature of the sales budgeting process at EWPL.

(ii) ADVISE on best approach from EWPL’s perspective that may be adopted.
Solution

(i) In participative budgeting, subordinate managers create their own budget and these budgets are reviewed by senior management. Such budget communicates a sense of responsibility to subordinate managers and fosters creativity. This is also called bottom up approach (sometime referred as participative approach).

As the subordinate manager creates the budget, it might be possible that the budget’s goals become the manager’s personal goal, resulting in greater goal congruence. In addition to the behavioural benefits, participative budgeting also has the advantage of involving individuals whose knowledge of local conditions may enhance the entire planning process.

The participative budget described here appears participative in name only. In virtually every instance, the participative input is subject to oversight and discussion by sales manager. Some amount of revision is also common. However, excessive and arbitrary review that substitutes a top-down target for a bottom-up estimate makes a deceit process. Such a gutting appears to be the case in EWPL. J’s statement indicates a very autocratic style. The revision process also seems to be arbitrary and capricious. There is little incentive for the salesgirls to spend much time and effort in projecting the true expected sales because they know that the target would be revised again and J’s estimate will prevail. This situation creates an interesting discussion about the costs and benefits of participative budgeting and gives rise to game playing and slack.

(ii) In top down approach, budget figures will be imposed on sales personnel by senior management and sales personnel will have a very little participation in the budget process. Such budget will not interest them since it ignores their involvement altogether. While in bottom up approach, each sales person will prepare their own budget. These budgets will be combined and reviewed by seniors with adjustment being made to coordinate the needs and goals of overall company. Proponents of this approach is that salespersons have the best information of customer’s requirements, therefore they are in the best position in setting the sales goal of the company. More importantly, salespersons who have role in setting these goals are more motivated to achieve these goals. However, this approach is time-intensive and very costly when compared with top down approach. In order to achieve personal goals, participants may also engage in politics that create budgetary slack and other problems in the budget system.

Since both top down and bottom up approaches are legitimate approaches, so EWPL can use combination of both. Seniors know the strategic direction of the company and the important external factors that affect it, so they might prepare a set of planning guidelines for the salesgirls. These guidelines may include forecast of key economic variables and their potential impact on the EWPL, plans for introducing and advertising a new product and some broad sales targets etc. With these guidelines, salesgirls might prepare their individual budget. These budgets need to be reviewed to validate the uniformity with the EWPL’s objectives. After review, if changes are to be made, the same should be discussed with salesgirls involved.
Use of Accounting Information in Performance Evaluation

Some dysfunctional consequences that arise with accounting measures of performance may not be due to the insufficiency of the performance measures, but rather may outcome from the way in which the accounting measures are used. The accounting information provided by an accounting system must be interpreted and used with care.

Hofstede (1968) found that stress on the actual results in performance evaluation led to more extensive use of budgetary information, and this made the budget more relevant. However, this stress was associated with a feeling that the performance appraisal was unjust. To overcome this problem, the correct balance must be established when the budgeted performance is evaluated.

Hopwood (1976) observed three distinct styles of using budget and actual cost information in performance evaluation in manufacturing division of a large US company:

- **Budget Constrained Style**: The evaluation is based upon the Cost centre head’s ability continually to meet the budget on short term basis.
- **Profit Conscious Style**: Performance of the Cost Centre’s head is linked to ability in increase the general effectiveness of his unit’s operations in relation to the long- term goals of the organisation.
- **Non- Accounting Style**: Accounting data plays a relatively unimportant part in the supervisor’s evaluation of the cost centre head’s performance.

### A Summary of the Effects of Three Styles of Management

<table>
<thead>
<tr>
<th></th>
<th>Style of Evaluation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Budget-Constrained</td>
</tr>
<tr>
<td>Involvement with Costs</td>
<td>High</td>
</tr>
<tr>
<td>Job-related tension</td>
<td>High</td>
</tr>
<tr>
<td>Manipulation of accounting information</td>
<td>Extensive</td>
</tr>
<tr>
<td>Relations with Superiors</td>
<td>Poor</td>
</tr>
<tr>
<td>Relations with Colleagues</td>
<td>Poor</td>
</tr>
</tbody>
</table>

To overcome these limitations a tool came into force known as Beyond Budgeting. Beyond Budgeting is a leadership philosophy that relates to an alternative approach to budgeting which should be used instead of traditional annual budgeting.

According to CIMA’s Official Terminology- ‘An idea that companies need to move beyond budgeting because of the inherent flaws in budgeting especially when used to set contracts. It is argued that a range of techniques, such as rolling forecasts and market related targets, can take the place of traditional budgeting.’

BB identifies its two main advantages.

- It is a more adaptive process than traditional budgeting.
- It is a decentralised process, unlike traditional budgeting where leaders plan and control organisations centrally.
Characteristics of Beyond Budgeting

Beyond Budgeting

- The rolling budgets may incorporate KPIs.
- Benchmarking can be incorporated in budgets.
- Here the focus of the managers shift to improving future results.
- Allow operational managers to react to the environment.
- Encourage a culture of innovation.
- More timely allocation of resources.

Suitability

Suitability of Beyond Budgeting

- Industries where there is rapid change in the business environment.
- Industries using management methods such as TQM.
- Industries undergoing radical change, e.g. using BPR.
- Flexible targets will be responsive to change.
- Continuous improvement will be the key.
- Budgets may be hard to achieve in such circumstances.
Benefits of the 'Beyond Budgeting' Model

- Beyond budgeting helps managers to work in coordination to beat the competition. Internal rivalry between managers is reduced as target shifts to competitors.
- Helps in motivating individuals by defining clear responsibilities and challenges.
- It eliminates some behavioural issues by making rewards team-based.
- Proper delegation of authority to operational managers who are close to the concerned action and can react quickly.
- Operational managers do not restrict themselves to budget limits and focus on achieving key ratios.
- It establishes customer-orientated teams.
- It creates information systems which provide fast and open information throughout the organisation.

Beyond Budgeting – Principles for Adaptive Performance Management

Process Principles

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STRATEGIC COST MANAGEMENT AND PERFORMANCE EVALUATION

<table>
<thead>
<tr>
<th>Goals</th>
<th>Set aspirational goals aimed at continuous improvement, not fixed annual targets.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rewards</td>
<td>Reward shared success based on relative performance, not on meeting fixed annual targets.</td>
</tr>
<tr>
<td>Planning</td>
<td>Make planning a continuous and inclusive process, not an annual event.</td>
</tr>
<tr>
<td>Controls</td>
<td>Base controls on relative key performance indicators (KPIs) and performance trends, not variances against a plan.</td>
</tr>
<tr>
<td>Resources</td>
<td>Make resources available as needed, not through annual budget allocations.</td>
</tr>
<tr>
<td>Co-ordination</td>
<td>Co-ordinate cross-company interactions dynamically, not through annual planning cycles.</td>
</tr>
</tbody>
</table>

Leadership Principles

- Customer
- Information
- Accountability
- Governance
- Performance
- Freedom to Act

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<table>
<thead>
<tr>
<th>Customer</th>
<th>Focus everyone on improving customer outcomes, not on meeting internal targets.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accountability</td>
<td>Create a network of teams accountable for results, not centralised hierarchies.</td>
</tr>
<tr>
<td>Performance</td>
<td>Champion success as winning in the marketplace, not on meeting internal targets.</td>
</tr>
<tr>
<td>Freedom to Act</td>
<td>Give teams the freedom and capability to act, don’t merely require adherence to plan.</td>
</tr>
<tr>
<td>Governance</td>
<td>Base governance on clear values and boundaries, not detailed rules and budgets.</td>
</tr>
<tr>
<td>Information</td>
<td>Promote open and shared information, don’t restrict it to those who ‘need to know’.</td>
</tr>
</tbody>
</table>

**Implementation of Beyond Budgeting**

There are nine steps that Hope and Fraser consider to be essential to implementing the Beyond Budgeting approach.

Source: *Beyond Budgeting: How Managers Can Break Free from the Annual Performance Trap* by Jeremy Hope, Robin Fraser
Traditional vs Beyond Budgeting Model

<table>
<thead>
<tr>
<th></th>
<th>Traditional Budgeting Management Model</th>
<th>Beyond Budgeting Management Model</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Targets and Rewards</strong></td>
<td>▪ Incremental targets</td>
<td>▪ Stretch goals</td>
</tr>
<tr>
<td></td>
<td>▪ Fixed incentives</td>
<td>▪ Relative targets and rewards</td>
</tr>
<tr>
<td><strong>Planning and Controls</strong></td>
<td>▪ Fixed annual plans</td>
<td>▪ Continuous planning</td>
</tr>
<tr>
<td></td>
<td>▪ Variance controls</td>
<td>▪ KPI’s &amp; rolling forecasts</td>
</tr>
<tr>
<td><strong>Resource and Coordination</strong></td>
<td>▪ Pre-allocated resources</td>
<td>▪ Resources on demand</td>
</tr>
<tr>
<td></td>
<td>▪ Central coordination</td>
<td>▪ Dynamic Coordination</td>
</tr>
<tr>
<td><strong>Organizational Culture</strong></td>
<td>▪ Central control</td>
<td>▪ Local control of goals/plans</td>
</tr>
<tr>
<td></td>
<td>▪ Focus on managing numbers</td>
<td>▪ Focus on value creation</td>
</tr>
</tbody>
</table>

Source: Beyond Budgeting Info- Centre http://www.juergendaum.com/bb.htm

Outlined by Jeremy Hope
Conclusion on Budgeting

It has been proposed that budgeting is alive and well, though practice is evolving with new tools and techniques. The conclusion are as follows:

- Budgeting is evolving, rather than becoming obsolete - it depends on trust and transparency.
- Shift from the top-down, centralised process to a more participative, bottom-up exercise in many firms.
- It highlights the level of improvement that can be achieved even with relatively simple modifications and a great deal of trust.
- Budgeting has changed, the change has been neither dramatic nor radical. Instead, incremental improvements, with traditional budgets being supplemented by new tools and techniques.
- Forecasting in fact is more important.

Source: 1-Better Budgeting A report on the Better Budgeting forum from CIMA and ICAEW July 2004- Driving Value Through Strategic Planning and Budgeting, p7,9; Debating the traditional role of budgeting in organisations, p 5.

SUMMARY

- Budgetary Control is “Systematic control of an organization's operations through establishment of standards and targets regarding income and expenditure, and a continuous monitoring and adjustment of performance against them.”

- Characteristics those are common to businesses with effective budgetary control include clarity of marginal responsibility, challenging and achievable business targets, establishment of data collection, analysis and reporting techniques, accountability of individual managers, shorter time periods, timely variance reports, timely actions to prevent variances.

- Feedback and Feed-forward Control – Feedback Control refers to ‘Measurement of differences between planned outputs and actual outputs achieved, and the modification of subsequent action and/or plans to achieve future required results. Feedback control is an integral part of budgetary control and standard costing systems.’
  - A feedback system would simply compare the actual historical results with the budgeted results.
  - Feed-forward Control is defined as the ‘forecasting of differences between actual and planned outcomes and the implementation of actions before the event, to avoid such differences.’

- Behavioural aspects of Budgetary Controls – Many of the conflicts arise due to the human nature of a budgetary control system. Managers do not always follow organisational goals, they do not always think long term, they may be wary of moving away from the plan etc.
provides a conflict between many of the goals of a budgetary control system which needs to be considered at a strategic level when implementing such a system.

- **Budget Slack** – Budget affects the attitudes and behaviour of managers and used to motivate the managers. Unrealistic demanding targets tend to affect manager’s performance adversely. Allowing managers to set their own targets will introduce slack targets. This helps satisfy one of the purposes of budgeting in that it can aid motivation. But it can have a detrimental impact on the other purposes such as distorting the evaluation of actual performance if managers incorporate ‘slack’ into the budget in order to make it easier to achieve.

- Budget level that motivates the best level of performance may not be achievable. In contrast, the budget that is expected to be achieved motivates a lower level of performance as managers no longer aspire to meet the budget target.

- **Participation in Budget Setting Process** – Budgets can be prepared centrally and subordinates have little influence on the target setting. This called top down budget or imposed style approach. The benefit of top down approach is that it can be produced quickly and involve less management time than other options. However, there are significant risk of inaccurate budgets being set that are also not acceptable to the subordinate managers. An alternative to top-down approach is for the subordinate managers to participate in the preparation of their own budgets and then these budgets to be reviewed by senior management. This is called bottom up approach (sometimes referred participative approach). Participation must be used selectively; but if it is used in the right circumstances, it has an enormous potential for encouraging the commitment to organisational goals, improving attitudes towards budgeting system, and increasing subsequent performance.

- **Circumstances Where Top-Down Budget Setting is Preferable** – Personality traits of the participation limiting the benefits of participation, lack of managerial motivation at individual level, highly programmable processes in the system, homogeneous units produced in stable environment.

- **Limitations of Traditional Budgets** – time consuming, costly, constrain flexibility and responsiveness, barrier to changes, contradictory, no focus on strategies, concentration on cost reduction and not value creation, developed too frequently, based on guess work, raises departmental barriers, discourage knowledge sharing, demotivate employees.

- **Beyond Budgeting** – An idea that companies need to move beyond budgeting because of the inherent flaws in budgeting especially when used to set contracts. It is argued that a range of techniques, such as rolling forecasts and market related targets, can take the place of traditional budgeting.

- **Characteristics of Beyond Budgeting** – The rolling budgets may incorporate KPIs based on the balanced scorecard which is linked to the organisation strategy, benchmarking with external players may help better evaluation, focus on improving future results rather than dwelling on past poor performances, allows operational managers to react to changing environment, encourages culture for innovation, flexible and do not rely on obsolete figures.
BUDGETARY CONTROL

- Suitability for Beyond Budgeting – Rapidly changing business targets, organisation using TQM/continuous improvement management techniques, organisations under business process reengineering.
- Benefits of Beyond Budgeting model – Internal rivalry among managers is reduced as focus shifts on competitors, motivating employees, proper delegation of authority of operational managers, customer-oriented teams, fast and open information across organisation.
- Steps essential for implementing Beyond Budgeting – Define the Case for Change and Provide an Outline Vision; Be Prepared to Convince the Board; Get Started; Design and Implement New Processes; Train and Educate People; Rethink the Role of Finance; Change Behaviour – New Processes, Not Management Orders; Evaluate the Benefits and Consolidate the Gains.

TEST YOUR KNOWLEDGE

Feedforward Control and Feedback Control

1. EW Partners, a leading strategy and management consulting firm is preparing its budgets for the year to 31 March 2020. One of partner ‘W’ is concerned about liquidity, he argued, that a firm with adequate liquidity has less risk of being unable to meet their liabilities than an illiquid one. Where a firm has adequate liquidity, there is also the possibility of enriched profitability through reduced interest outlay or increased interest income, together with greater financial flexibility to negotiate enhanced terms with suppliers and financiers or participate in new business opportunities. Accordingly, he desires to reduce the firm’s CC to zero by 30 September 2019 and to have a positive cash balance of ₹145,000 by the end of the year.

Required

COMPARE and CONTRAST feedforward control and feedback control in context of the above information.

Participative Budget

2. SPM, a leading school of management in the heart of India’s financial centre of Mumbai, preparing its budget for 2019. In previous years, the director of the school has prepared the budget without the participation of senior staff and presented it to the school board for approval.

Last year the SPM board blasted the director over the lack of participation of his senior staff in the budget process for 2018 and requested that for the 2019 budget the senior staff were to be involved.

Required

LIST the potential advantages and disadvantages to the SPM of involving the senior staff in the budget preparation process.
Behavioural Aspects of Budgetary Control

3. History of the Company

Great Bus Tours Co. Ltd. (GBTCL) is an open top double-decker bus sightseeing company, particularly identified with its special red and cream-colored buses. It commenced operating in small town of Meghalaya in June 2014 with four buses and as of 2018 operated over 44 buses in north east region of India. GBTCL operates five routes with stops at tourist destinations. The company runs hop-on, hop-off bus tours of various hills, with one 24-hour ticket valid for unlimited journeys on the route.

Budget Process/ Incentive Plan

As a part of management performance control and incentive scheme it has been following participative budgeting approach. In GBTCL, budgeting is a joint process in which functional divisions develop their plans in conformity with corporate goals for the next financial year. Based on these plans, divisions prepare functional budgets and send to the appropriate management for review and approval. The budgets after the incorporation of the feedback and suggestions received from the said management, are finalised for the implementation. Then, finalised budgets are used as yardstick for performance measurement. Comparing the actual performance with the yardstick, bonus and other performance related incentives are considered. The higher management believe that this performance control and incentive scheme is very helpful to measure the performance and fixing responsibilities for the responsibility centres.

Budgeted Income Statement (₹'000)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (₹'000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>1,13,800</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Variable Costs</td>
<td></td>
</tr>
<tr>
<td>Direct Material (Fuel, Lubricants and Sundries)</td>
<td>13,600</td>
</tr>
<tr>
<td>Direct Labour</td>
<td>40,500</td>
</tr>
<tr>
<td>Variable Overheads</td>
<td>7,700</td>
</tr>
<tr>
<td>Fixed Costs</td>
<td></td>
</tr>
<tr>
<td>Operating Overheads (Buses, Garage, Salaries)</td>
<td>18,100</td>
</tr>
<tr>
<td>Marketing and Administration</td>
<td>10,700</td>
</tr>
<tr>
<td>Profit/ (Loss) before taxes</td>
<td>23,200</td>
</tr>
</tbody>
</table>

Tabel-1

Current Year’s Income Statement (₹’000)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (₹’000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>93,500</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Variable Costs:</td>
<td></td>
</tr>
<tr>
<td>Direct Material (Fuel, Lubricants, and Sundries)</td>
<td>19,600</td>
</tr>
<tr>
<td>Direct Labour</td>
<td>37,700</td>
</tr>
</tbody>
</table>
Other Information

Surprisingly above given current year’s actual results were not up to the mark. Actual results were clearly showing adverse performance in comparison with budgeted figures.

Managers of GBTCL were upset because they did not receive the bonus. Ms. Maggie, Tour Manager of Route No. 3, said –

“We lost 2 month’s revenue and fuel prices are almost doubled. We did our best but these circumstances were beyond our control and we should not penalize at all.”

In support of her statement, Ms. Meggie provided following additional information –

(a) Rain is common in Northern Region. But, the past year set a record in numbers. In July, the expected average was 1,577 mm and received was 1,810 mm. In August the expected average rain was 990 mm and actual received was 1,535 mm. Heavy rain in these two months disrupted normal life of the region.

(b) The fuel prices have risen almost continuously since last year due to surge in global crude prices.

(c) Additional operational expenses ₹22,00,000 also incurred to remove the milky appearance and give the stainless a nice new look effected by heavy rain.

She claimed that –

“Revised budget with consideration of the above factors would give different results and lead to different conclusions”

Required

ANALYSE the tour manager’s view.

Beyond Budgeting

4. The Board of Directors meeting of Kyoto Motors Ltd., a car manufacturing company is to be scheduled to be held in another ten days. One of the items, as per agenda, to be discussed in the meeting is the present budgeting system of the company. Your organisation is at present, using budgets for control which are prepared mostly on traditional basis. The CEO of your company wants to propose to the Board to use Beyond Budgeting instead of traditional budgeting in the company on experimental basis. Therefore, you, the Management Accountant has been asked by your CEO to explore the possibilities of introducing Beyond Budgeting (BB) system in the company.
**Required**

Specifically, you are required to PREPARE notes to your CEO to be used for his presentation at the meeting on:

(i) the major limitations of traditional budgets.

(ii) the advantages available in Beyond Budgeting.

(iii) the nature of Beyond Budgeting.

(iv) the benefits that can be enjoyed from Beyond Budgeting.

(v) the suitability of Beyond Budgeting to the company.

**ANSWERS/ SOLUTIONS**

1. In feed-forward control instead of actual results being compared against desired results, *forecasts are made of what results are expected to be at some future time*. If these expectations differ from what is desired, control actions are taken that will minimize these gaps.

   In the scenario, EW Partners has following 2 expectations–

   - the first of these is to reduce the CC to zero by 30 Sep 2019 and
   - the second is to have a positive cash balance of ₹145,000 by 31 March 2020.

   Therefore, to achieve above expectations, a cash budget will be prepared based on various functional budgets showing cash inflows and outflows for each month so that the firm can identify its anticipated monthly cash balance. This can then be compared with the firm’s expectations to see if their cash balance objectives are being achieved. However, if the objectives are not met by these budgets, these budgets may need to be revised by changing the levels of activities. It is the process of *feedforward control*.

   Feedback control involves monitoring results achieved against desired results and taking whatever corrective action is necessary if a deviation exists.

   Thus, in the case of EW Partners, a comparison of the actual monthly cash balance can be made against the budgeted cash balance for that month. As with any budget and actual comparison there may be an adverse or favorable variance. If this is substantial, then further analysis may be needed to determine its reason. It may be that costs above budgets, cash receipts lower than expected or receivables took less time to pay than expected, or payables were paid later than expected. This comparison process is *feedback control*.

   **Conclusion**

   Feedforward control attempts to take corrective action before an event, whereas feedback control takes corrective action after the event.
2. There are potential advantages and disadvantages of the involvement of staff in the preparation of the budget.

Potential advantages include:

- Senior staff may agree to accept the targets because they would take ownership of it as their budget.
- Senior staff may have a better understanding of what results can be achieved and at what costs. For example, they may have a better knowledge of individual courses and how they may be delivered more efficiently and cost effectively.
- Senior staff cannot blame unrealistic goals as an excuse for not achieving budget expectations.
- Senior staff would feel that they are being appreciated for the value that their experience brings to the running of the management school.
- Senior staff may get the opportunity to discuss organisational issues, in which an exchange of information and ideas can help to solve problems and agree future actions.

Potential disadvantages include:

- Senior staff may be excellent academically but could lack the practical knowledge required to formulate their budget.
- Senior staff may limit the benefits of participation due to personality traits of participants.
- Senior staff may consume a great deal of time arguing with each other (and with the school director).

Senior staff may decide among themselves to artificially inflate the proposed budget so that it is easier for them to attain the cost targets they have set.

3. Analysis of Issue

It appears that GBTCL has been badly hit by the weather – high rain in July and August have led to a slump in business. Revenue have seen a fall of 18% over the budgeted figure. Direct Material (most of the fuel) is 21% of the Sales (compared to 12% of budgeted level) because of hike in fuel price. Variable Overheads are almost same. However, interestingly, there is a saving of ₹1,50,000 in Operating Overheads as compared to the budgeted figure after catering additional Operational Expenses of ₹22,00,000 (for removal of milky appearance etc.). Furthermore, there is reduction in Marketing & Administration Cost. The ratio of Salary to Sales rose to 40% in 2018 from 36% (as budgeted). This appears to be atypical. Instead, there should be a cut in this ratio due to slump in business.

Award of bonus in case of losses is not justified and managers should be held accountable for their operations. However, they should not be held accountable for the events beyond their control. A manager cannot control movements in fuel price, yet he/ she is supposed to have the most information and he/ she is expected to correctly forecast movements in the prices of fuel. Managers shouldn't be penalized for the uncontrollable events.
Accordingly, in GBTCL, there should be revision in the budget to account *uncontrollable events*. Refer Table-3.

*Revised Budgeted Income Statement (₹000)*

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td>94,833</td>
</tr>
<tr>
<td><strong>Less:</strong></td>
<td></td>
</tr>
<tr>
<td>Variable Costs-</td>
<td></td>
</tr>
<tr>
<td>Direct Material** <em>(Fuel, Lubricants, and Sundries)</em></td>
<td>19,879</td>
</tr>
<tr>
<td>Direct Labour</td>
<td>33,750</td>
</tr>
<tr>
<td>Variable Overheads</td>
<td>6,417</td>
</tr>
<tr>
<td>Fixed Costs-</td>
<td></td>
</tr>
<tr>
<td>Operating Overheads <em>(Buses, Garage, Salaries)</em></td>
<td>20,300</td>
</tr>
<tr>
<td>Marketing and Administration</td>
<td>10,700</td>
</tr>
<tr>
<td><strong>Profit/ (Loss) before taxes</strong></td>
<td>3,787</td>
</tr>
</tbody>
</table>

Tabel-3
*10 months revenue; ** at actual price levels

The Revised Profit Margin has come down to 4% as against the Target Profit Margin of 20%. This clearly indicates that the performance was benchmarked against the higher target. If original budget figure is used to measure the performance, it will punish employees for the reason which are beyond their control.

GBTCL is not too far away from Revised Profit Margin. Therefore, at least some bonus may be considered to be awarded to the employees which may create more *employee loyalty* and may be beneficial for long term.

Further, *continuous monitoring* of Budget Performance (achievement/ failure) in GBTCL is essential to overcome this situation. This helps to identify where *revisions* are required in the budget to account changing conditions, errors, modification to company’s plan etc. Monitoring of Budget Performance should be the responsibility of the managers in GBTCL. The essence of the effective monitoring of Budget Performance is that the managers should provide *accurate, relevant, actionable* information on time to the appropriate management level so that budget can give a realistic target to measure the performance.

It is also important to note that at the time of revising the budget, the primary budget as well as past information should not be ignored as they are the basis for preparing all budgets.

4. **(i) Limitations of Traditional Budgets**
   - Time-consuming and costly to put together.
   - Constrain responsiveness and flexibility.
   - Often a barrier to change.
Rarely strategically focused and are often contradictory.
Add little value, especially given the time required to prepare.
Concentrate on cost reduction and not on value creation.
Developed and updated too infrequently, usually annually.
Are based on unsupported assumptions and guesswork.
Reinforce departmental barriers rather than encourage knowledge sharing.
Make people feel undervalued.

(ii) **Advantages of Beyond Budgeting (BB)**

BB identifies its two main advantages.

- It is a more *adaptive* process than traditional budgeting.
- It is a *decentralised* process, unlike traditional budgeting where leaders plan and control organisations centrally.

(iii) **Nature of *Beyond Budgeting***

- Budgeting is *evolving*, rather than becoming obsolete- it depends on trust and transparency.
- Shift from the top-down, centralised process to a more *participative*, bottom-up exercise in many firms.
- It highlights the *level of improvement* that can be achieved even with relatively simple modifications and a great deal of trust.
- Budgeting has changed, the change has been neither dramatic nor radical. Instead, *incremental improvements*, with traditional budgets being supplemented by *new tools and techniques*.
  - *Forecasting* in fact is more important.

(iv) **Benefits of the *Beyond Budgeting* Model**

- Beyond budgeting helps managers to work in coordination to beat the competition. Internal rivalry between managers is reduced as target shifts to competitors.
- Helps in motivating individuals by defining clear responsibilities and challenges.
- It eliminates some behavioural issues by making rewards team-based.
- Proper delegation of authority to operational managers who are close to the concerned action and can react quickly.
- Operational managers do not restrict themselves to budget limits and focus on achieving key ratios.
- It establishes customer-orientated teams.
- It creates information systems which provide fast and open information throughout the organization

(v) Suitability of Beyond Budgeting to the Company

Since Kyoto Motors Ltd. is a car manufacturing company and presently adopting Traditional Costing system. Moreover, Automobile industry goes through rapid changes in its business environment. So, the company can definitely use Beyond Budgeting to improve the control system and beat the competition. Beyond Budgeting lies an agile, holistic approach based on self-organisation. This will also help the managers to work in close coordination with each other with motivation which in turn will beat the competition.