Discuss the Limitations of Budgeting

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The Limitations of Budgeting

Budgeting is one of the most important management concepts in business. It is very widely used by both profit and non-profit organisations. According to Dawn (2003), 69% of companies in Europe still operate their day to day activities with formalised traditional budgeting systems. While it has benefits of forecasting the future development of an organisation and its environment, coordinating activities and tasks, promoting communication between departments and motivating employees (Webber & Linder, 2005), budgeting has also been found to have a number of limitations. This paper will discuss some of these limitations which include consuming too much time and cost, providing little reliable and valuable information, adding little value and wasting resources, encouraging parochial and non-ethical behaviour as well as de-motivating employees.

Budgeting is a time-consuming and costly job. The development of a budget includes many repetitive steps before the budget is finally approved. As an example, participative budgeting (which is supposed to be a better model) involves managers at all levels (and sometimes all of the employees) developing their own initial estimates for sales, costs, etc. This process requires lots of negotiations between managers at different levels until a budget evolves which is acceptable to all levels (Langfield-Smith, Thorne & Hilton, 2006). Bartrum (2006) cites the Hackett Group’s research to demonstrate that even the most efficient companies take 79 days to plan their budgets, while the worst take 210 days to complete the whole process. The Ford Motor Company has calculated that they spent $1.2 billion annually for budgeting (BBRT, 2006). This is because it involves many people in the organisation and absorbs up to 20 to 30 percent of top executives’ and financial managers’ time.

Compared with its costs, budgeting provides little valuable, reliable and relevant information. In the main, budgets are based on assumptions that often turn out to be inaccurate. Budgets are generally backward-looking and inward-oriented instead of
being market-oriented; therefore, they inevitably provide irrelevant and unreliable data to the users. In addition, lack of enough time to analyse data, maintaining consistency and obtaining data to analyse the budgeting figures, also explain some of the problems (Abrams, 1982). One 1999 global best practices study shows that only 21% of finance staff time was spent on analysing the budgeting numbers while 79% of their time was spent on valueless activities (BBRT, n.d.). This can explain some of the reasons why low value, unreliable, sometimes almost useless information is submitted to the management.

Hope and Fraser (1997) argue that with the big changes in the business world, intellectual assets accounting for 80-90% of market capitalisation. While many companies recognise that the underlying source of future cash flows increasingly comes from the effective management of intellectual assets, it is beyond the capability of budgets to properly account for these intellectual assets. In other words, only 10 – 20% of a company’s value can be analysed by its budget. Banks in Scandinavia using budgets have an average 70% of cost/income ratio. In contrast, Svenska Handelsbanken which does not utilise budgeting has a 45% cost/income ratio (Hope & Fraser, 1997). This shows that budgets add little or no value to shareholders’ assets. Budgets are rigid, restricted and fixed to artificial period. The budget period can be too long to adapt today’s dynamic and quickly changing market; conversely, the fiscal year may be too short-term horizon for planning and steering some major activities of today’s companies, like R&D, brand development or growing business relationships between partners and potential customers. So budgets can restrict or hinder business and organisational development in the long run while adding little, if any, value to the business.

Budgets also cause great deal of waste and behavioural problems. Hope and Fraser (1999) cite Jack Welch, from General Electric as claiming that making a budget is an exercise in minimalisation – you are always getting the lowest out of people, because everyone is negotiating to get the lowest numbers. People’s main goal is to meet the budgets, so they always try to negotiate to get lower targets with lower sales and higher costs, which are well-known as padding the budgets. These days, many managers judge their status on the size of their budgets rather than their ability to create economic value.
for their shareholders or customers. Despite slack sales budgets, people also try to spend all of their obtained budgeting funds rather than use what they need. There are some other budgeting games conducted by people, such as cooking the books. When sales have exceeded the budget, people delay booking the revenue. Conversely, they forward book revenue if they are behind the budgets. All of these sorts of behaviour make the budgeting system lose credibility and cause waste. On the other hand, the current common rewarding practice also promotes people’s non-ethical behaviour. When trying to meet the fixed budgets to obtain bonuses, people are encouraged to focus on the things affecting their bonus, rather than things that may be more important, such as long-term investment, R&D and customers’ satisfaction (Daum, 2004). Interestingly, surveys show that non-financial quality measures dominate the effects of financial measures when both are included in the regression. Non-financial measures often create a focus on the future, as opposed to historical financial measures which create a focus on the past. (Hirschey et al., 2001, as cited by Maines, Bartov & Fairfield, 2002). This actually may give some clues why budgeting figures fail to provide reliable prediction for future business running. Budgets also reinforce a dependency culture and de-motivation of employees i.e. “do what you told, meet the budget”. It encourages people to avoid taking risks, thereby stifling product development and innovation.

In conclusion, budgeting is a major management activity, and while it has some useful functions for businesses and organisations, it does have great limitations. Budgets consume substantial levels of time and other resources, but provide little credible and useful information. They add little value but encourage dysfunctional and wasteful behaviours as well as de-motivate employees. In recent years, a group of financial experts from BBRT have been advocating implementation of Beyond Budgeting, which is suggested to be more flexible, less sophisticated and less complex, but more efficient and effective in the current Information Age business world.
References:


Bartrum P. (2006) Forecasting the end for budgets *Director* (e-version), London August 2006 Vol. 60, Iss. 1; pg. 30, 3pgs

BBRT (n. d.) *About Beyond Budgeting - The Budgeting Problem. 10 reasons why budgets cause problems* retrieved on 11 September 2006 from website of the Beyond Budgeting Round Table (BBRT) www.bbrt.org/bbprob.htm

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Hope J. & Fraser R. Beyond budgeting... Breaking through the barrier to “the third wave” *Management Accounting* (e-version) Dec 1997 pg20;4pgs


Webber J. & Linder S. (2005) Budgeting, better budgeting or beyond budgeting *Cost Management* (e-version) Boston, Mar/April 2005 Vol. 19, Iss. 2; pg20, 9pgs

Some good stuff listed. But not presented in accordance with APA Style.
This guide will be used to mark your essay. Please read it before you start writing.

**ORGANISATION**
- Introductory paragraphs which clearly indicate direction, convey purpose, clarify any assumptions and give the scope of paper: [Overall: Good structure]
- Layout of paper – clear, direct and logical:
- Clear links made between sections, major issues and stated purpose:
- Clear summaries and concluding paragraph:

(Circle which term is an appropriate description) Mark out of: Excellent Very Good Good Fair Weak 25 (30)

**DISCUSSION/ARGUMENT**
- Shows evidence of relevant research and reading:
- Statements are accurate, clear, and well supported:
- Main issues are well addressed:
- Relevant information is used:
- Purpose of the paper always evident:
- Consistency of argument and language:

(Circle which term is an appropriate description) Mark out of: Excellent Very Good Good Fair Weak 35 (40)

**WRITTEN EXPRESSION**
- Well written:
- Sound sentence construction:
- Grammatically sound:
- Well-proofed, absence of spelling errors:

(Circle which term is an appropriate description) Mark out of: Excellent Very Good Good Fair Weak 14 (20)

**REFERENCING**
- Follows APA referencing in the body of the work and in reference list:
- References support argument, are relevant:
- Sources properly acknowledged:

(Circle which term is an appropriate description) Mark out of: Excellent Very Good Good Fair Weak 7 (10)

**FINAL GRADE**

8/100

= 16.2/20.