Budget in modern multinational companies

Executive summary

Lots of people realised that fixed budgets don't work in the 21st century. The mechanics of the budgeting process are inefficient and it locks managers into the past - into something they thought last year that it was right. We understand that better financial performance comes from competitive strategies, not from better financial management. The focus of budget is on financial outputs and excludes other performance measures. To be effective in a global economy with rapidly shifting market conditions and quick and nimble competitors, organization have to be able to adapt constantly their priorities and have to put their resources where they can create most value for customers and shareholders. In order to do that, they need the right concepts, management processes and tools.

Recommondation:

- Managers and their companies should be able to react more quickly to market changes. They shouldn't be restricted to an artificial and too long period such as the fiscal year to reconcile budgets with the business environment and to adapt them.
- Benchmarking approaches enable firms to compare their performance with best-in-class results elsewhere as well as with internal peers.
- Enterprisewide information systems and rolling financial forecasting have a key role to play in making the strategy-focused Scorecard a success.
- Balanced Scorecard enables all employees to focus on strategy rather than numbers. But it is more likely to reach its full potential if there is no budgeting barrier to act as a counterforce that drives managers toward meeting this year's targets.
- Activity based management systems can lead to radical decentralization with local managers having the freedom and capability to act with minimal central control and without budgets.

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1. Introduction

Today we can sense a growing dissatisfaction among CEOs, CFOs and business managers and across the whole business community with the traditional general management approach, which is based on budgetary control - with a fixed annual performance contract, fixed action plans for an entire year and a highly political budgeting process dominated by "gaming" as the result. Managers increasingly doubt if today's pervasive budgeting culture in many multinational organizations can support successful enterprise management and proper corporate governance.

This report seeks to initially analyse the problems accrued in budgetary control nowadays. Based on this analysis, some appropriate solution of findings will allow us to become more dynamic and to not just focus on financials, but to manage the strategy of the group in multinational companies.

2. Criticisms of budget

The problems associated with traditional budgeting have been recognized for some time. The team from the Centre for business performance at Cranfield School has addressed 12 main criticisms for budgeting.

Budgets are time-consuming. A KPMG study showed (Fraser and Hope, 2001) that inefficient budgeting eats up 20 to 30 per cent of senior executives' and financial managers' time. Many surveys present the fact that financial managers need to take more than three months to produce and sign off their annual budgets. This means that the budgets are out of date as soon as they are produced. Whilst in 21st century, budgets are inappropriate for the 'information age'.

At the same time, budgeting has become even more expensive, yet adds less value than expected. Budgets absorb over 20% of total management time; 77% of time does not add value. (Daum, 2003)

Criticisms also include stifling initiative, lacking strategic direction. In Fraser and Hope's research (2001) addressed the phenomenon that 60 per cent of management teams in the survey which don't link strategy and budgeting; and 85 percent spend less than one hour a month discussing strategy. It also causes dysfunctional behaviour, as they will do anything to 'meet their numbers'. Because the budget is functioning as a fixed annual performance contract, it forces managers to stick to the budget, no matter what changes, opportunities and threats occur on the market.

In addition, the budget-based performance management system is too inwardly focused. It guides managers to look in the wrong direction and to pay too much attention to input factors such as costs and nearly no attention on output factors, such as customer satisfaction or in general. It also causes managers to act to achieve their short-term targets at the expense of long-term value creation.

As a multinational company trade in the global market, worldwide events have a more dynamic impact, and as product life-cycles have shortened, budgets have became more inaccurate. Under half of UK organizations expressed a desire to reforecast and re-budgeting their budgets more frequently in order to manage future business performance (Knowles, 2005). In other words, the annual cycle based is unsuitable for multinational companies facing rapidly changing markets.

3. Budget in modern companies

More companies in resent years saw the budgeting system as a 'tool of repression'. No wonder, that many companies are looking for improving the traditional budget-based way of steering and managing their business. In a recent survey, conducted by The Hacket Group among European companies (Daum, July 2003), 69% of the companies reported that they are still using traditional budgeting (3% have already no budgets, 28% use a reengineered approach), but that most of them intend to replace it within the next 2 years through a reengineered approach or even abandon budgeting at all.

4. What is a Budget

When we are discussing about budgeting or abandoning budgeting, first of all we should define what a budget is. We can easily find lots of different definitions about it. Somehow, it depends on to whom you are talking to, and the understanding of what a budget is can be very different. Just as Juergen Daum (2004) said, 'nobody would know exactly what it means, what will be stopped and what will still continue.'

5. Innovation in Budgetary control

The traditional budgetary control systems should be reengineered. Budgetary control relates to the establishment of budgets relating the responsibilities of budget holders the needs of a policy.

5.1 Benchmarking

Performance measurement takes place using benchmarking with the competitors. The European Benchmarking Code of Conduct define Benchmarking is simply about making comparisons with other organizations and then learning the lessons that those comparisons throw up. It allowed us to focus on the market or beating the competitor, and producing the necessary flexibility for this - not on meeting a budget agreed on in the past. As Hope and Fraser (2003) presented, benchmarks can be used to set medium-term goals within the framework of the Balanced Scorecard. These goals can be based on competitor or peer performance levels and used to display performance within league tables that act as a primary motivator for operating managers. Benchmarks can also use Activity Based Management cost based measures to set medium-term goals.

5.2 Rolling financial forecasting and enterprisewide information system

One of the first things that become very clear is that we have to separate financial forecasting from target setting and performance management. You never will get accurate and honest forecasts if bonuses and performance appraisal of people are linked in some way with these forecasts. So the introduction of rolling financial forecasting will look beyond the fiscal year. Implementation of rolling financial forecasting is as an independent tool and process, independent from target setting and performance management.

Within the company individual managers have designated areas of budgetary responsibility. By achieving their compartmentalized budgetary target, they need to analyze and correct their localized variance. A devised enterprisewide information system determines the total performance of the branches on the basis of a few KPIs and makes this information available to all managers at the same time. And they are more likely to support key decision makers at the front line if these systems are fast and transparent.

5.3 Activity-based management system

Activity based management systems are useful to empower front-line managers. But a climate of responsibility and trust must be created to allow fast responses to competitors. Knowing which products and customers are profitable after charging all the costs of supporting them is perhaps the most important information that can be made available to decision makers. Activity-based management can lead to radical decentralization with local managers having the freedom and capability to act with minimal central control and without budgets. In other words, they can no longer hide in the nooks or making excuses for poor performance. It is a win-win situation for the organization and its employees.

5.4 Balanced scorecard

The management model used by most organizations today is not up to the job. It was designed to enable leaders to plan and control their originations from the centre. Their designs never take account of enabling business unit throughout the organization to focus on creating value for customers and shareholders. The balanced scorecard has provided a strategic framework to help overcome of those problems. ‘The Balanced Scorecard was designed to enable managers to map and describe their strategy, to balance short- and long-term goals, initiatives and measures, to align the actions of the ‘top floor’ and the ‘shop floor’, and to focus on the real drivers of financial performance.’(Fraser and Hope, 2003) The Balanced Scorecard gave us a broader perspective in performance management than the traditional budget, which was focusing just on the financial numbers. But most scorecards still play fiddles to a core management process driven by the annual budgeting cycle. Managers may will remain focused on achieving short-term financial results, therefore you will fail to become a more strategy-focused and adaptive organization.

6. Conclusion

The traditional fixed annual budget systems are increasingly unsuited to modern business. At multinational companies, the emphasis is on managing performance over business cycle. New techniques such as the Balanced Scorecard and Activity- based management are bale to help managers understand their business success factors and cost drivers better. Fixed costs are controlled through Activity- based management; targets are set by the ‘Balanced Scorecard’ process, and it will contain more than just budgetary information, but some problem may remain. By separating re-forecasting process from the budget, rolling forecast allow to increase speed and accuracy and reduce the management time involved. Those tools allow the decentralization becomes more efficient in multinational companies and operations will have better performances and gain a great competitive success in the modern world.

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