Budgeting

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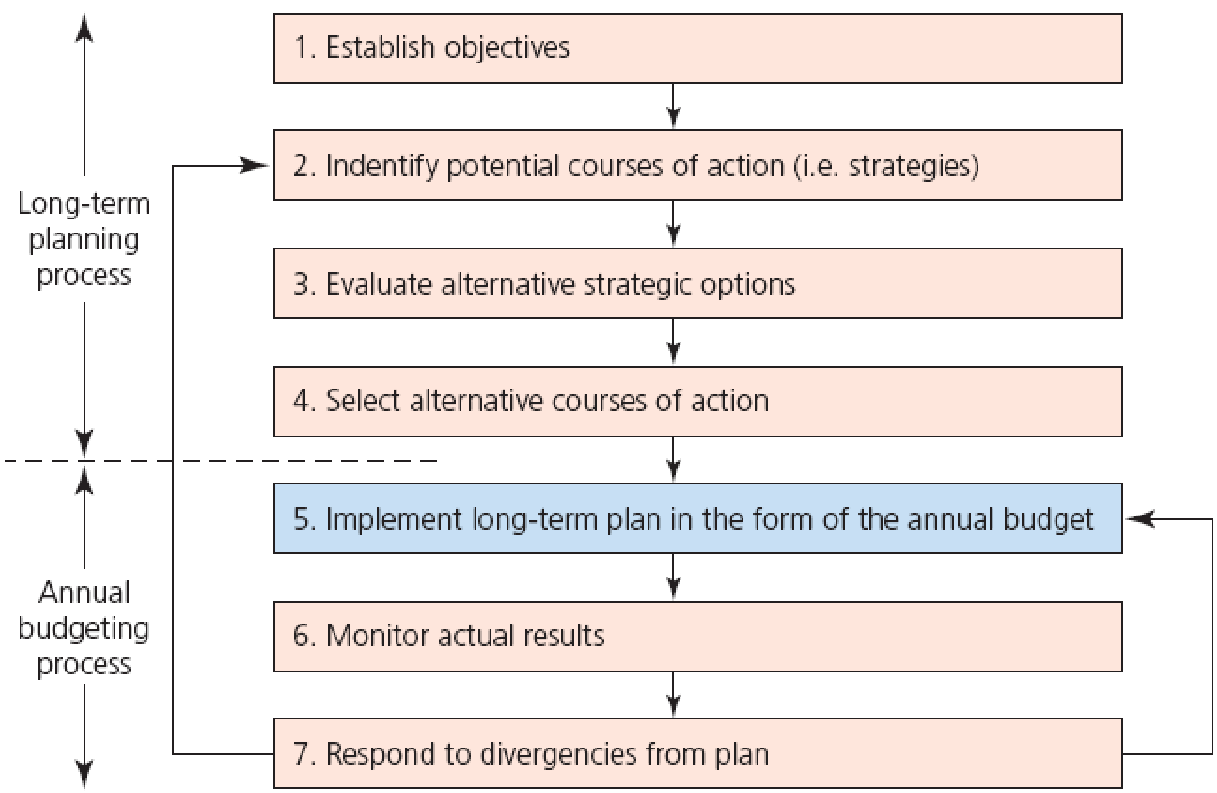
This short article provides an overview of some of the key aspects of budgeting. First, it describes a budget and how it fits in an organisation's strategic planning process. Next, it outlines the purposes of budgeting, why budgets are prepared. This is followed by a brief summary of budget preparation and the types of budgets that are produced. The distinction between fixed and flexible budgets is then presented and two common forms of budgeting, incremental and zero based are described. Finally, some behavioural issues arising from the budgeting process are outlined.

Budgets and the strategic planning process

An organisation develops its strategic or long term objectives and identifies, evaluates and selects suitable courses of action to achieve those objectives. An annual *budget* is an integrated part of the strategic (long term) planning process as it represents one such course of action. A budget is a detailed plan of action prepared for a specific period of time, usually twelve months.



(Source: Drury, 2015)

Purposes of budgets – why prepare budgets? (Figure 1)

To aid the ***planning*** of operations by forcing managers to consider how conditions might change and what steps should be taken now.

To ***co-ordinate*** the activities of the organisation by compelling managers to examine relationships between their own operations and those of other departments.

To ***communicate*** plans to various responsibility centre managers so that everyone in the organisation has a clear understanding of the part they are expected to play in achieving the annual budget.

To ***motivate*** managers to strive to achieve the budget goals by focusing on participation and providing a challenging target.

To ***control*** activities by comparison of actual with budget (this is attention directing/management by exception).

To ***evaluate*** the performance of managers by providing a means of informing managers of how well they are performing in meeting targets they have previously set.

(Drury, 2015)

Figure 1: The purposes of budgeting

Preparation of budgets

In many organisations, detailed monthly budgets are prepared once a year. Prior to the budgeting process, a budget manual may be prepared by the accountant describing the objectives and procedures involved in developing the overall budget for the organisation. A budget committee is established comprising top executives from all functions of the business who receive and approve individual budgets from departmental managers. The management accountant, with the assistance of accounting staff, co-ordinates these individual budgets into an overall budget for the organisation.

Typical budgets produced

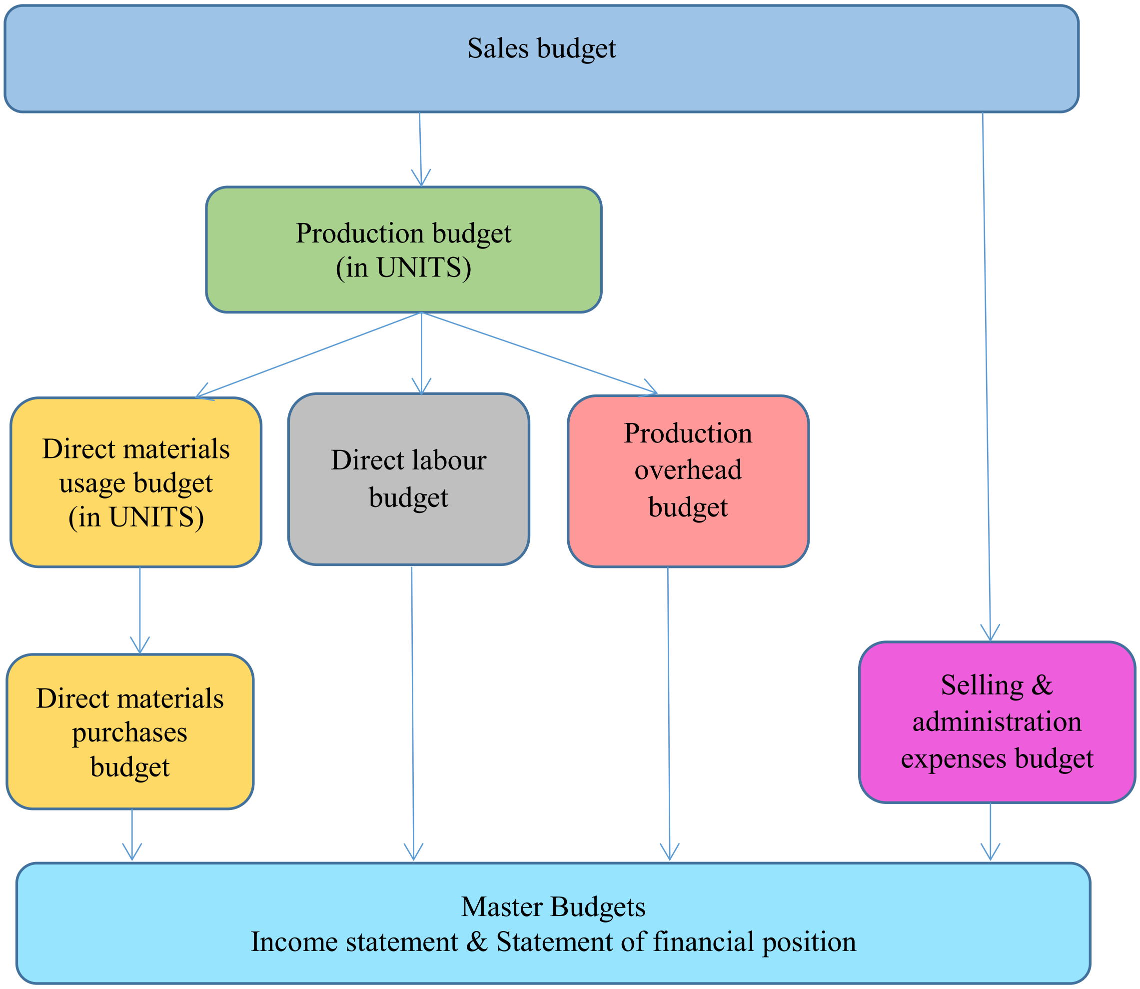
Organisations may produce functional budgets and cash budgets.

Functional budgets relate to the activities of the organisation and provide details of expected sales, materials and labour costs, anticipated production costs and non-manufacturing overhead expenses (see Figure 2).

Functional budgets comprise:

- Sales budget (in units and € value)
- Production budget (in units only)
- Direct materials usage budget (in units only)
- Direct materials purchases budget (in units and € value)
- Direct labour budget (in hours and € value)
- Production overhead budget (in € value)
- Selling and administration expenses budget (in € value)
- Master budget = budgeted income statement (profit & loss account) and statement of financial position (balance sheet) (in € value)

Cash budgets are prepared in monetary terms and focus on cash receipts and payments including income received from customers and payments to suppliers for goods and for other expenses.



Fixed and flexible budgets

In budgeting a distinction is made between two forms of budget, a fixed budget and a flexible (or flexed) budget.

A fixed budget, once developed and agreed, is not changed or altered if actual activity differs from budgeted activity.

A flexible budget is ‘ a budget which, by recognising the difference in behaviour between fixed and variable costs in relation to fluctuations in output, turnover, or other variable factors such as number of employees, is designed to change appropriately with such fluctuations’ (Griffith College Manual).

A flexible budget is prepared based on actual activity and shows what the budgeted costs and revenues would have been if the budget had been based on actual activity achieved. A flexible budget thus allows comparison of actual and budgeted costs and revenues based on the same activity level. It is much more useful than a fixed budget as it allows more meaningful variances to be calculated.

Incremental budgeting

Incremental budgeting starts with the budget from the previous period and adds or subtracts an incremental amount to cover inflation and other known expenses. It is suitable for stable businesses, where costs are not expected to change significantly and where there is good cost control and limited discretionary expenses.

Advantages/benefits of incremental budgeting	Disadvantages/drawbacks of incremental budgeting
Quick and easy method of budgeting	Carries forward previous problems and inefficiencies to the next budgeting period
Only the increment (extra amount) needs to be justified in organisations that have stable and historic figures	Uneconomic activities may be continued
	Managers may spend unnecessarily to use up their budgeted expenditure to ensure that they will get the same or a larger budget next year

Zero based budgeting (ZBB)

Zero based budgeting (ZBB) emerged in the late 1960s as a response to incremental budgeting. With ZBB, all budgets start at zero and activities/costs are only allowed if they are justified under investigation. All requests for resources must be presented and they are evaluated on the basis of cost-benefit – i.e. where is the value in the spend? ZBB is best suited to discretionary spending where there is no clearly defined input-output relationship (e.g. marketing, research & development, training, etc.) or public sector organisations such as local councils.

Advantages/benefits of ZBB	Disadvantages/drawbacks of ZBB
Should reduce inefficiencies as past waste is not carried into the next year	Expensive and time consuming process
Cost-benefit analysis approach – promotes focus on organisational activities and costs	In a highly pressured environment it may become overly competitive
Questions are asked, rather than just accepting figures	Can give rise to a short-term focus to the detriment of long term goals
Inefficient or obsolete operations can be identified and discontinued	Managers may feel demotivated due to the large amount of time spent on the budgeting process
ZBB leads to increased staff involvement as more information and work is required to complete the budget	Budgeting process may become too rigid and unable to react to unforeseen opportunities or threats
Resources should be allocated efficiently and economically	The necessary management skills to apply ZBB may be absent
ZBB responds to changes in the business environment	

Behavioural issues arising from the budgeting process

Earlier in the article the purposes of budgeting were outlined. Three of these purposes specifically relate to behaviour, *control*, *evaluation* and *motivation*. Budgets facilitate control over costs by highlighting any differences arising between actual costs and budgeted costs. Budgets are used to evaluate managerial performance and also to motivate staff to perform better. Consequently it is important to address these three aspects when developing budgets otherwise behavioural problems may arise. Examples of potential problems/issues that may arise and how they may be avoided are noted below.

Control

- Budgets facilitate comparison of planned outcomes with actual results allowing the organisation to improve sales performance, monitor capital expenditure projects, forecast cash flows and control expenditure levels. In terms of behavioural consequences, it is important that managers understand the budgeting process when the organisation is trying to reduce and control its expenditures. Better understanding of the budgeting process should promote a more questioning approach towards potential costs and discourage inefficiencies from being carried forward from one year to the next.

Evaluation

- If managers are being evaluated and possibly remunerated based on budgeted outcomes, these outcomes must be within managerial control i.e. controllable by the manager rather than by head office for example. If the manager has limited or no control over budgeted outcomes he/she may consider any evaluation based on these outcomes as unfair and become less motivated to improve performance.

Motivation

- If managers are not involved in developing the overall budget for the organisation they will be less committed and motivated to achieve the desired results. However, sometimes when managers are involved in the budgeting process they may attempt to secure easier, less challenging targets. Managers may include some 'budgetary slack', which means that budgeted costs may be overstated and budgeted revenues may be understated.

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