Chapter 8

Budgeting

Outcome

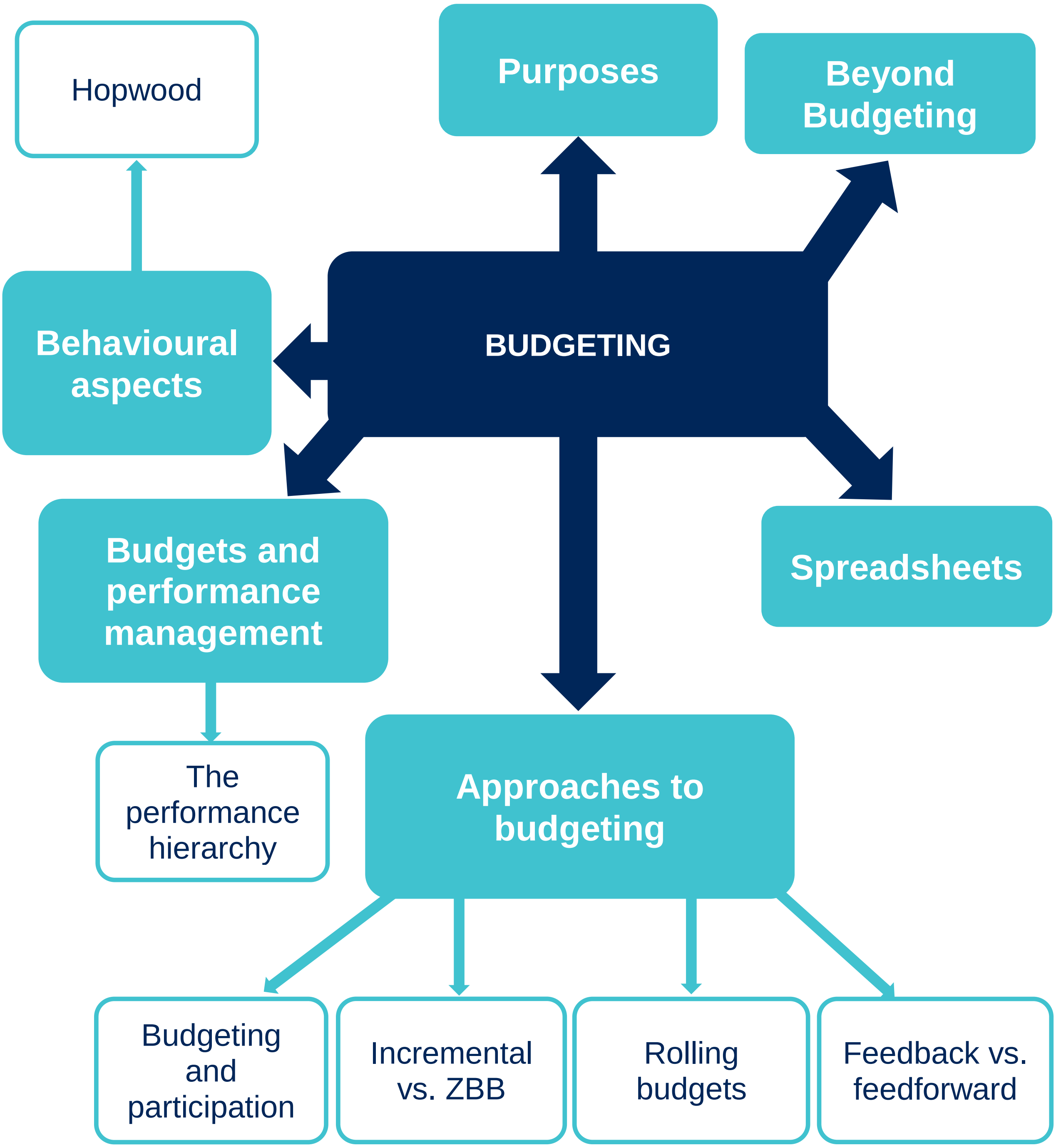
By the end of this session you should be able to:

- explain why organisations use budgeting and how budgetary systems fit within the performance hierarchy
- describe the factors which influence behaviour at work and 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 and evaluate 'top down' and 'bottom up' budgetary systems; 'rolling', 'activity-based', 'incremental' and 'zero-based' budgetary systems.
- explain and evaluate 'feed-forward' budgetary control
- describe the information used in various budgetary systems and the sources of the information needed
- explain the difficulties of changing a budgetary system and type of budget used, and how budget systems can deal with uncertainty in the environment
- explain the major benefits and dangers in using spreadsheets in budgeting

and answer questions relating to these areas.

The underpinning detail for this Chapter in your Integrated Workbook can be found in Chapter 8 of your Study Text

Overview


Hopwood
Purposes
Beyond Budgeting
Behavioural aspects
BUDGETING
Budgets and performance management
Spreadsheets
The performance hierarchy
Approaches to budgeting
Budgeting and participation
Incremental vs. ZBB
Rolling budgets
Feedback vs. feedforward

1 Purposes of budgets

A budget is a quantitative plan prepared for a specific time period. It is normally expressed in financial terms and prepared for one year.

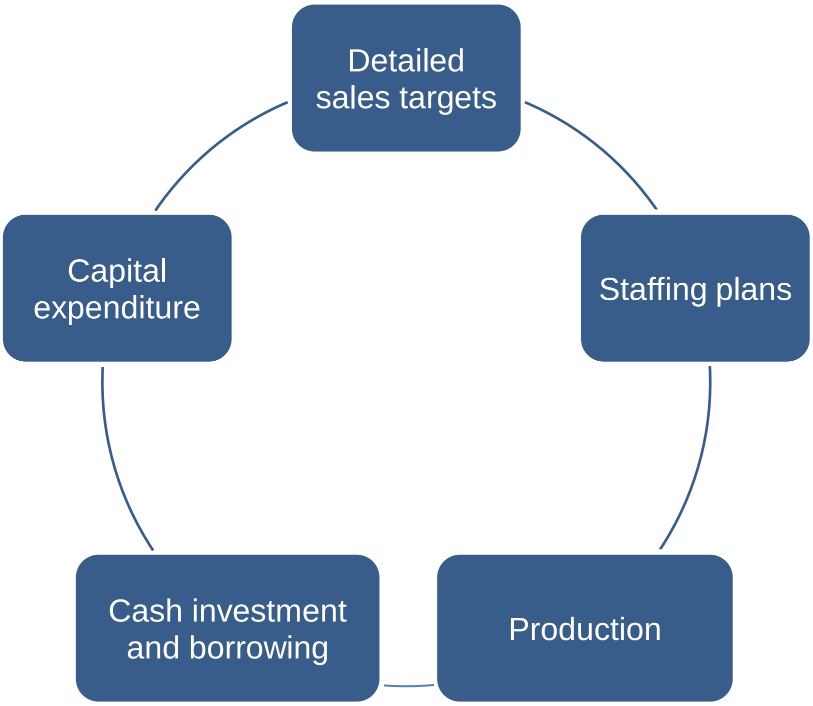
Purposes:

- **P**lanning – forces organisation to look into the future and plan ahead
- **R**esponsibility – should motivate managers and result in better targets
- **I**ntegration – of all parts of the organisation/levels of staff towards common goals
- **M**otivation – manager's rewards based on achievement of budgetary targets
- **E**valuation – of performance by comparing actual to budgeted performance

Notes

2 Budgets and performance management

Budgets contribute to performance management by providing benchmarks against which to compare actual results (through variance analysis), and develop corrective measures. They take many forms and serve many functions, but most provide the basis for:



It is an essential facet of the planning and control process. Without a budget, an organisation will be highly inefficient and ineffective.

Notes

3 The performance hierarchy

Firms have a planning hierarchy:

- Strategic planning is long term, looks at the whole organisation and defines resource requirements. For example, to develop new products in response to changing customer needs.
- Tactical planning is medium term, looks at the department/divisional level and specifies how to use resources. For example, to train staff to deal with the challenges that this new product presents.
- Operational planning is very short term, very detailed and is mainly concerned with control. Most budgeting activities fall within operational planning and control. For example, a budget is set for the new product to include advertising expenditure, sales forecasts, labour and material expenditure etc.

Notes

The aim is that if a manager achieves short-term budgetary targets (operational plans) then there is more chance of meeting tactical goals and ultimately success for strategic plans. The achievement of budgetary plans will impact on the eventual achievement of the tactical and strategic plans. However, budgets should also be flexible in order to meet the changing needs of the business.

Illustrations and further practice

Now try TYU 1 'Evaluation of managers' on Chapter 8.

Notes

4 Behavioural aspects of budgeting

Individuals react to the demands of budgeting and budgetary control in different ways and their behaviour can damage the budgeting process. Behavioural problems are often linked to management styles, and include dysfunctional behaviour and budget slack.

4.1 Management styles (Hopwood)

Budget constrained style ➢ Manager evaluated on ability to achieve budget in the short term ➢ Manager will be criticised for poor results. For example, if spending exceeds the limit set	➢ Job related pressure ➢ May result in short-term decision making at the expense of long-term goals ➢ Can result in manipulation of data
Profit conscious style ➢ Manager evaluated on ability to reduce costs and increase profits in the long term	➢ Less job related pressure ➢ Better working relations with colleagues ➢ Less manipulation of data
Non accounting style ➢ Manager evaluated mainly on non-accounting performance indicators such as quality and customer satisfaction	➢ Similar to profit conscious style but there is less concern for accounting information ➢ Requires significant and stringent monitoring of performance against budget

Notes

5 Setting the difficulty level of a budget

Expectations budget

- A budget set at current achievable levels.
- Unlikely to motivate managers to improve but may give more accurate forecasts for resource planning, control and performance evaluation.

Aspirations budget

- A budget set at a level which exceeds the level currently achieved.
- This may motivate managers to improve if it is seen as attainable, but may also result in an adverse variance if it is too difficult to achieve.

Illustrations and further practice

Now try TYUs 2 and 3.

Notes

6 Approaches to budgeting

6.1 Budgeting and participation

Top down budgeting (non-participative) imposed

Imposed on budget holder by senior managers

- Avoids dysfunctional behaviour and budgetary slack
- Quick
- Senior managers retain control
- Senior managers understand needs of whole organisation

Bottom-up budgeting (Participative)

Divisional managers set the budget

- More realistic budgets
- Improved motivation
- Improved divisional managers' understanding
- Frees up senior managers' time

Illustrations and further practice

Now TYU 4 from Chapter 8.

Notes

6.2 Incremental budgets, zero-based budgets (ZBB) and rolling budgets

Type of budget	Suitability	Advantages
Incremental – starts with the previous period's budget or actual results and adjusts these by an incremental amount to cover inflation or other expected changes	➢ Stable business ➢ Good cost control ➢ Limited discretionary costs	➢ Quick, low cost and easy ➢ Managers not demotivated by targets changing regularly ➢ Fine if historic figures accurate
ZBB – each element of the budget is justified as if the activity to which the budget relates is being undertaken for the first time **ZBB stages:** (1) Managers identify activities that can be individually evaluated (2) The costs and benefits of each activity are included in a decision package (3) The activities are ranked (4) Resources allocated to various packages	➢ Fast moving business ➢ Historic figures inaccurate ➢ High discretionary costs ➢ Public sector organisations	➢ Inefficient/obsolete operations identified and removed ➢ Better resource allocation ➢ Involvement of managers improves knowledge and motivation ➢ Responds to changes in the business environment

Type of budget	Suitability	Advantages
Rolling – the budget is kept continuously up to date by adding another accounting period (e.g. month/quarter) when the earliest accounting period has expired	➢ Fast moving organisation ➢ New business ➢ Any organisation that needs cost control	➢ Budgeting and control should be more accurate ➢ Managers take budgeting process more seriously

Illustrations and further practice

Now TYU 4, 5, 6 and 7 from Chapter 8 as well as Illustration 1 ‘Rolling budgets’.

Notes

6.3 Activity based budgeting (ABB)

Activity based costing

Let's begin by recapping our costing knowledge from Paper F5.

Absorption costing (AC)	Activity based costing (ABC)
Aim: to calculate the full production cost per unit **Assumes** production overheads are driven by the level of activity	**Aim:** as per AC, i.e. to calculate the full production cost per unit **Recognises** the diversity and complexity of modern production meaning that not all production overheads are driven by level of activity

Steps:

1. Group production overheads into activities (**cost pools**), according to how they are driven
2. Identify **cost drivers** for each activity
3. Calculate an overhead absorption rate (**OAR**) for each activity
4. **Absorb** activity costs into products
5. Calculate the **full production cost/unit** and profit/(loss) (if required)

Illustrations and further practice

Now try TYU question 8 from Chapter 8 'Preparing an ABB'.

Notes

Advantages

- An understanding of what drives costs should improve cost control
- More accurate cost per unit resulting in better:
  - pricing
  - cost control
  - decision making

Disadvantages

- Cost and time involved
- Limited benefit if production overheads are minimal or mainly driven by level of production
- Difficult to identify cost pools and drivers

Illustrations and further practice

Now try TYU question 9 from Chapter 8.

Notes

7 Changing a budgetary system

A change in the budgetary system could bring about improved planning, control and decision making.

However, before a change is made the following issues should be considered:

- Are suitably trained staff available to implement the change successfully?
- Will changing the system take up management time which should be used to focus on strategy?
- All staff involved in the budgetary process will need to be trained in the new system and understand the procedure to be followed in changing to the new approach. A lack of participation and understanding builds resistance to change.
- All costs of the systems change, e.g. new system costs, training costs, should be evaluated against the perceived benefits. Benefits may be difficult to quantify and therefore a rigorous investment appraisal of the project may be difficult to prepare.

Notes

8 Spreadsheets

A spreadsheet is a computer package which stores data in a matrix format where the intersection of each row and column is referred to as a cell. They are commonly used to assist in the budgeting process.

Advantages of spreadsheets

- Large enough to include a large volume of information.
- Formulae and look up tables can be used so that if any figure is amended, all the figures will be immediately recalculated. This is very useful for carrying out sensitivity analysis.
- The results can be printed out or distributed to other users electronically quickly and easily.
- Most programs can also represent the results graphically e.g. balances can be shown in a bar chart.

Notes

Disadvantages of spreadsheets:

- Spreadsheets for a particular budgeting application will take time to develop. The benefit of the spreadsheet must be greater than the cost of developing and maintaining it.
- Data can be accidentally changed (or deleted) without the user being aware of this occurring.
- Errors in design, particularly in the use of formulae, can produce invalid output. Due to the complexity of the model, these design errors may be difficult to locate.
- Data used will be subject to a high degree of uncertainty. This may be forgotten and the data used to produce, what is considered to be, an 'accurate' report.
- Security issues, such as the risk unauthorised access (e.g. hacking) or a loss of data (e.g. due to fire or theft).
- Version control issues can arise.
- Educating staff to use spreadsheets/models and which areas/cells to use as inputs can be time consuming.

Illustrations and further practice

Now try Illustration 4 ‘Using spreadsheets in budgeting’.

Notes

9 Beyond Budgeting

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

9.1 Beyond Budgeting – 6 principles

A BB implementation should incorporate the following six main principles:

- An organisation structure with clear principles and boundaries; a manager should have no doubts over what he/she is responsible for and what he/she has authority over; the concept of the internal market for business units may be relevant here.
- Managers should be given goals and targets which are based on relative success and linked to shareholder value; such targets may be based on key performance indicators and benchmarks following the balanced scorecard principle.
- Managers should be given a high degree of freedom to make decisions; this freedom is consistent with the total quality management and business process reengineering concepts; a BB organisation.
- Responsibility for decisions that generate value should be placed with 'front line teams'; again, this is consistent with TQM and BPR concepts.
- Front line teams should be made responsible for relationships with customers, associate businesses and suppliers; direct communication between all the parties involved should be facilitated; this is consistent with the SCM concept.
- Information support systems should be transparent and ethical; an activity based accounting system which reports on the activities for which managers and teams are responsible is likely to be of use in this regard.

Notes

Questions

You should now be able to answer test your understanding questions 1 to 14 from Chapter 8 of the Study Text.

You will be able to answer questions 96 to 109 from the Exam Practice Kit; partly answer questions 213 to 215 and 258 to 261.

For further reading, visit Chapter 8 from the Study Text and read the F5 article on 'Comparing Budgeting Techniques' at www.accaglobal.com

Notes