Budgeting

Specification requirement—understand the purpose and nature of budgets and their limitations

A budget is a financial plan of action normally covering a specific time period, say six months or one year. A budget will describe expected levels of expenditure and revenues of a business or part of a business. Large businesses will prepare budgets on a departmental basis or in relation to business functions. So for example a business will have an overall budget based upon the budgets of departments such as marketing, purchasing, personnel, and capital expenditure etc.

All budgets should be objective driven. This means that the expected revenues and expenditures of each department will be ultimately based on what the firm is trying to achieve. So if a business has the objective of increasing sales by 20%, then the overall budget and departmental budgets should reflect this.

The Budgeting Process

Budgeting and monitoring of budgets is an ongoing procedure in large businesses. The monitoring involves feedback, checking of targets, reference to budget holders etc. So budgets should be continually evolving to adapt to changes. This evolution should though be controlled and based on the firms understood budgetary process.

Typically the budgetary process will involve the following procedure.

1. Establish the aims and objectives of the business - what are our profit targets, market share targets, what is our targeted turnover? These targets must be realistic, made within understood limits of the market and availability of resources. If not, they will have no meaning.

2. Set Production, Marketing and Financial budgets. These are the 3 main functional budgets and each is dependent upon the objectives of the business.

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Production budget - the objectives of the firm have established the output levels required. The production budget attempts to put these output levels into practice. So it will involve costs of purchasing raw materials and components, direct labour costs and other costs of production. This is an expenditure only budget.

Marketing budget. Here we combine both revenues and costs. Revenues from sales predicted and costs from operating the firms marketing strategy.

Financial budget. This will be based upon the firm's cash flow forecast. Will income, be able to cover expenditure or will we have to examine methods of raising funds to finance other budgets.

3. Next the budget should be further broken down. Within each of these budgets, there is the opportunity to break budgets down further, so there may be a training budget, a health and Safety Budget, a direct selling budget etc.

4. Procedures for monitoring budgets should be established.

5. Any variance from predicted budgets should be examined and reacted too.

6. The experience and knowledge gained from setting one period's budgets, should be applied to the setting of the following period's budgets.

Benefits of Budgeting

The budgeting process has important benefits for a business. These benefits include:

- **Improved management control of the organisation.** Managers know who is spending what, and why they are spending the money
- **Improved financial control.** Part of the budgeting process is monitoring of expenditure and revenues. Any changes from (variances from) budgeted amounts need to be explained and reacted too.
- **Allows managers to be aware of their responsibilities**. Managers who are in control of their budgets are aware of what they should be achieving, and how their role fits in with organisational objectives.
- Budgeting ensures, or should ensure, **that limited resources are used where most effective**. The budgeting process allocates resources to where they are most likely to help achieve the firms objectives.
- **Budgeting can motivate managers.** When managers at all levels are involved in the budgeting process they will have a commitment to ensuring that budgets are met.
- **Can improve communication systems within organisation.** The budgeting process itself will involve communication both up and down the hierarchy, establishing formal methods of communication, which can be used for purposes other than setting and administering budgets.

Problems with budgets.

The budgeting process itself can cause problems. These include.

- **Those excluded from the budgeting process, may not be committed to the budgets and may feel demotivated.**
- **If budgets are inflexible then changes in the market or other conditions may not be met by appropriate changes in the budget**, e.g. if a competitor start a major new advertising campaign, and the marketing budget does not allow for a response to this, sales are likely to be lost.
- **Also an effective budget can only be based on good quality information**. Many managers overstate their budgetary needs to protect their departments; this leads to lack of control and poor allocation of resources.

Methods of Setting Budgets

Historical

Base the budget on last years spending, plus an amount for inflation.

Objective Based

Budget based on what the firm is trying to achieve.

Zero Budgeting.

Zero budgeting involves managers starting with a clean sheet; they have to justify all expenditure made. This improves control, helps with allocation of resources and limits the tendency for budgets to increase annually with no real justification for the increase.

Competitor Based.

This method is often used when setting advertising budgets, when matching competitor spends is needed to maintain market share.

Funding Based

With this method a budget is directly related to income, so a staff budget may be 20% of sales.

Budgetary Control.

The basis of budgetary control is variance analysis. A variance is any unplanned change from the budgeted figure.

Variances can be Favourable (F) or Adverse (A)

A favourable variance occurs when expenditure is less than expected or revenues are higher than expected.

An adverse variance occurs when expenditures are higher than expected, or revenues are lower than expected. Budgets must be monitored for variances, so that they can be reacted to. Because each budget has a budget holder (the person responsible for the budget), then responsibility for variances can be trace to the right person.

Calculation of Variances.

Calculation of variances is relatively simple. The actual figure must be compared with the budgeted figure and the difference shown as either Favourable (F), or Adverse (A). These variances should then be totalled, to gain an overall Favourable (F) or Adverse (A) figure.

	Budgeted	Actual	Variance
Sales Revenue	£163,000	£179,000	£16,000 (F)
Raw Materials	£73,000	£81,000	£8,000 (A)
Labour	£41,000	£43,000	£2,000 (A)
Total Variance			£6,000 (F)

Remember that ; A favourable variance occurs when expenditure is less than expected or revenues are higher than expected.

An adverse variance occurs when expenditures are higher than expected, or revenues are lower than expected.

Variances are always in £ value, not quantity, after all a budget is a financial statement.

Conclusion.

Budgets are an important management tool, they help with financial control, help co-ordinate business activity and can motivate staff, but a poorly prepared budget is valueless, it wastes time, can demotivate, and may restrict business activities so that management cannot react to changes in the market place.

Notes