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# 9

# The Use of Budgets in Organisations

## 9.1 Introduction and objectives

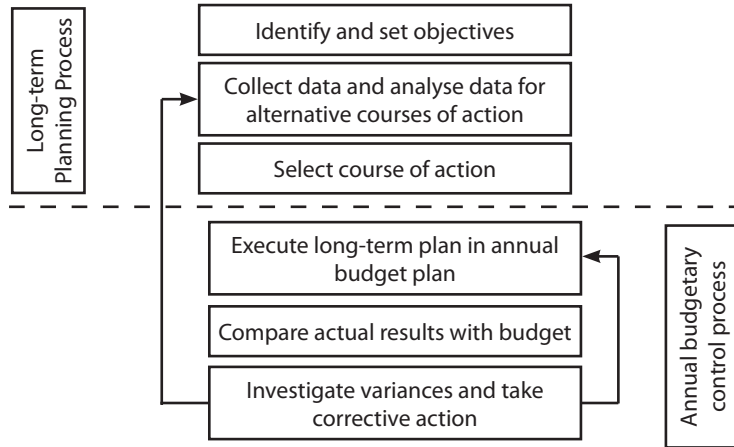
Budgeting is a popular management accounting tool – often quoted as the most commonly used management accounting tool. However, that does not mean it is universally accepted in the 21st century and is not without its critics.

After studying this chapter you should be able to:

- Explore the development of budgeting
- Consider the role of budgets within organisations
- Develop budget preparation skills
- Consider the behavioural implications of budgeting
- Evaluate the use of budgets in contemporary business environments

Planning can be divided into two main phases, long-term strategic, corporate level planning and short-term planning (within one year). Detailed budgets normally assist in the short-term phase, as is illustrated in Figure 9.1.

It can be seen that using a budget fulfils many roles across the organisation. The first use of budgeting dates back over 100 years, and they were initially designed for use in a manufacturing environment. In this chapter the traditional role of budgets within service sectors, how they have developed and the future of budgets in the 21st century are all considered. As with any managerial accounting technique, there are advantages and disadvantages to budgeting which need to be explored. There is also much to discuss concerning the human behaviour aspects of budgeting, beyond just the calculation of the figures.



**Figure 9.1:** The relationship between long-term and short-term budgeting

## 9.2 The role of budgets

There can be many uses of budgets within an organisation. The key two that are mentioned in most academic literature on the subject are for planning and control. However, if a business is going to the effort of producing a budget, it would be sensible to know what other uses it could be put to. Work by Jones (2008a, 2008b) suggested hospitality organisations mainly used budgets for control and performance measurement, in addition to their role in planning.

The key to the success of a budget's success is whether they have been planned with much forethought and sensitivity – in these circumstances they can have many advantages:

- They can aid **planning**, which gives a business direction. A budget takes the organisational plan (goal and objectives) and quantifies this into something tangible to aim for. Such forward planning aids anticipating future business conditions and helps avoid otherwise unforeseen problems.
- Budgets have a role to play in **control** within an organisation. So it can be used to measure **performance** against the targets set in the budget. There are alternative performance measurement tools, as discussed in other chapters – whatever their merits the budget remains the mainstay of performance measurement in many organisations.
- The budgeting process can encourage **communication** between departments/employees and aid in the **coordination** of a firm's activities. The budget can be used to communicate financial plans throughout the different parts of the organisation – thus showing how the different parts fit together to form an integrated plan for the organisation as a whole.
- There is also argued to be a **motivational** role for the budget – if set at the appropriate level. The argument being that the budget gives managers a target

to strive towards. However there is also an argument that if set at an inappropriate level (too high or too low) it can have the reverse impact and can demotivate.

## 9.3 Master budget preparation

There are many approaches to preparing a budgetary plan, each having its merits. So the considerations before even looking at the figures and preparing the budget include:

- *Should the budget be prepared for a fixed financial year, or be a rolling budget?* The most commonly used approach to budgeting is for a fixed financial year for example 1st April 20X1 – 31st March 20X2. Typically 3–4 months before the start of the financial year the budget preparation starts and the budget for a full 12 months is completed and approved for use prior to the start of the year. This means the budgeting process takes place once a year, but the disadvantage can be in, for example January 20X1 you are trying to make predictions of what will be happening in March 20X2, so can the figures be realistic? An alternative is to have a rolling budget, where every month a budget is prepared for a further month as the current month ‘rolls off’ the budget – so in March 20X1 you write a budget for March 20X2. With a rolling budget, budgeting becomes a continuous process and you always have 12 months ahead. Whilst it can have benefits the annual budget is the most common approach, setting the budget for a whole financial year at a time. Some organisations argue this is what their external lenders (banks) require.
- *Is the best approach ‘top-down’, or ‘bottom-up’?* In a hierarchical organisation it has to be agreed who is involved in writing the budgets. The traditional approach is ‘top-down’, where budgets are initiated and initially drafted at head office level in the organisation and then passed down the organisation for comment, negotiation and agreement. The alternative, despite the title, still starts at the top of the organisation – higher level management in the ‘bottom-up’ approach initially set key targets and direction and then managers at lower levels complete the first detailed draft of the budgets. Budgets then work up the organisation. The behavioural aspects of budgeting are dealt with later in this chapter in detail, but generally it is believed that the more managers have full involvement in preparing their own budgets the greater their commitment to achieving them.
- *Do we need a budget committee or a budget manual?* These are traditional tools to assist in the development and approval of budgets, however there is limited evidence of their use in industry these days. There is an argument that a budget manual takes a lot of time to prepare and can become out of date so it is far easier to just add guidance notes into budgetary spreadsheets – these are easily accessed and updated.