

The process of budgeting and its uses



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“ Budgeting is an important control system in almost all organizations (Armstrong et al., 1996; Ekholm and Wallin, 2000; Merchant and Van der Stede, 2003 cited in Hansen and Van der Stede)”. In an organisation all the activities are coordinated together by preparing plans for the future. These plans are called as Budgets. “ A budget can be defined as the quantitative expression of a plan action and an aid to coordination and implementation of the plan” (Kennedy A and Dugdale D(1999). Long term planning is taken into consideration while preparing the budget. According to Colin Drury, budgets are the clear indicators of what a company will expect in the coming year. Budgeting is very useful tool for the companies to protect their future as it provides a system of authorisation and acts as a mean to forecast and planning. In a globalised civilization, Innovation is a key to success (Marginson D and Ogden S (2005). The question arises is that does budgeting and innovation go hand in hand? Budgeting harms trust and authorisation which in turn affects innovation according to many critics. All the leading companies in this age want their products to be new and innovative. Does that mean they do not use budgeting? These are some of the question which instantly arises in the minds of a consumer or a student who is doing an academic research on budgeting. In this essay we will discuss the uses of budgeting and make an attempt to discuss the validity of the criticism levelled at the traditional budget in the modern organisations.

A company prepare budget in order to get a clear picture of the future. It is carried in the context of long term strategic planning. This planning is then converted into budgeting process. Budgeting process is the process of preparing long term plan or strategic plan for the organisation. According to

Kennedy A and Dugdale D (1999), while preparing budgets we should follow a series of steps. Following are the steps of preparation of budget:

Establish the mission and objectives

Determining the limiting factor example sales

Setting up the budget restricted by limited factor

Set different budgets in accordance with objectives

Mix all the budgets to form a master budget

Accept the master budget

Monitor the actual results with the budgeted plan.

The budgeting process is simple to understand and easy to implement. But still budgeting has been the area of criticism (Hope and Fraser (1999); Ekholm and Wallin (2000)). According to Hope and Fraser (1999a), in this information age traditional budgeting has not been able to meet the demands of the competitive environment. Many critics of the budgeting are management consultants themselves with an interest of changing the models of their management. Marginson and Ogden believed the opposite of Hope and Fraser. They performed a case study on a company called Astoria which is a leading player in global technological area. The main conclusion of this study was Innovation and budgeting go hand in hand. The company used an innovative management control system (aggregated variance analysis) and this allowed innovation to be accounted with the budgetary process.

Kennedy A and Dugdale D (1999) believe in getting most from the budgeting but also believe that the problem in the budgeting arises because of the purpose it serves. Budget serves a number of useful purposes such as a means of forecasting and planning, a system of authorisation, a source of decision making, motivational device and evaluating the performance of managers.

Annual budgeting process leads to betterment of the long term plans set by an organisation. Managers sometimes make hasty decision which can hamper the growth of plans set. Budgeting process encourages managers to anticipate the problems in the future. According to Kennedy and Dugdale two budgeting models should be made, one for planning and forecasting and the other for motivational reason. Planning a budget process takes a lot of time and becomes a costly affair (Mike B, Andy N and Herman H (2002)). This has been one of the most frequent criticisms about the budgeting.

One of the uses of budgeting is Motivation. A budget is a device used for influencing managerial behaviour and motivating the managers to perform the objectives of the organisation. It acts as a motivational device by providing a challenge to the managers. Colin Drury believes that budget helps managers to coordinate the activities of the organisation and achieve organisational goals. Budgeting helps organisation to run smoothly and effectively. This is because of the proper lines of communication which will allow managers and other staff understand what part they need to carry out or perform (Colin Drury (2009); Hansen s and Van der Stede w (2004)). A research shows that budgeting encourages ‘ gaming’ situation between

superiors and the subordinates during the target setting (Mike B, Andy N and Herman H (2002)).

Budgeting allows a manager to control and manage the activities of the organisation. When the actual results are compared with planned results there is a chance that some of the costs don not conform to the original plan which makes necessary for the manager to give an attention. This system is called Management by exception.

A Budget provides a means of evaluation of the performance of the managers. The performance of the managers is evaluated by measuring the success he has achieved in achieving the targets set by the manager (Colin Drury, 2009). This use of budgets helps influencing the behaviour of humans. There are many other useful purposes of budgeting but I laid an emphasis on only a few of them which would be helpful for a debate on budgeting in contemporary organisations.

Budgeting has been a very important subject of academic researchers. But not many academic researchers have been able to address criticism publicly made by the practitioners and the management consultants. (Ekholm and Wallin, 2000). According to Hope and Fraser (2000) the most useful management accounting model is functional based model which focuses on command and control. But in this information these types of models have become inefficient and are not effective as they were. They claimed a different technique called process based management model should be used instead which will help in coping to new environment by developing empowerment and not the budgets. Marginson and Ogden completely

disagree with the statements of Hope and Fraser about not using the budgets. A research shows that most of the leading business use budgeting in various different forms.

When we have a closer look at the system of annual budgets these are time consuming (Mike B, Andy N and Herman H (2002)), reduces the performance of managers (Mike B, Andy N and Herman H (2002); Hansen s and Van der Stede w (2004)), encourages rigid planning and incremental thinking and are focused on cost rather than value creation. A research shows 80 per cent of the businesses are not satisfied with their budgeting techniques (Mike B, Andy N and Herman H, 2002). Most of the financial directors rank budgeting as their first reform for coming years. A budget is prepared on an annual basis which has been criticised as these ties a company into 12 month commitment with the budget which can be a risk for the business as budgets are based on unsure forecasts. Hope and Fraser (1999c) argue that the budget cannot cope with environmental uncertainty. Rolling forecast methods have been suggested as the main alternative to annual budget method as it is produced monthly or quarterly (Arterian, 1998; Hope and Fraser, 1999a).

In a research many companies were surveyed who still are using planning and budgeting processes but many of the companies no longer used the word budget. New approaches are being used instead. Many companies including Electrolux have started using rolling forecast method. Nowadays, most organizations have recognized that the traditional budgeting is the greatest barrier to achieve the goal. The traditional budgeting is described as “ Bane of corporate America” and “ tool of repression”. Svenska

Handelsbanken has stopped using the annual budget method (Mike B, Andy N and Herman H, 2002).

Many accountants believe that Activity-based Budgeting (ABB) and 4P-based Budgeting (PBB) are the most widely approaches used by the modern organizations all over the world. In contrast, Dugdale and Lyne (2006) surveyed 40 different UK companies. His survey included survey on financial and non financial managers. The main conclusion was that traditional budgeting is still alive and not dead. The companies he surveyed were all using budgets and the managers of all the companies agreed that budgeting and its process is still necessary along with other techniques of performance evaluation, communication and coordination. This survey led because of the beyond budgeting movement by Hope and Fraser. The study by Ekholm and Wallin shows that traditional budgeting is still a very important and integral part of an organisation. Their study also shows that practitioners are willing to accept the criticism but they are not ready to forgo the traditional budget.

Thus, the situation of traditional budgeting working in modern organisation is still a debatable issue. But one could argue that, traditional budgeting is required for maintaining organisation's internal effectiveness. On the other hand, traditional budgeting does not seem to aid in value creation based on external effectiveness of organisation External effectiveness can be achieved by strategic means, but an organisation cannot achieve its objectives unless internal effectiveness is low. Therefore the annual budget, along with other methods, still has strong and important role to play.