The importance, benefits and issues of budgeting

Introduction

This report is aimed to evaluate the importance of budgeting, analysis the benefits and problems that brought by budgeting and also discusses the behavioral aspects of budgeting. A budget is a comprehensive, formal, coordinated, detailed, quantitative plan that estimates the probable expenditures for acquiring and using financial and other resource for an organization over a specific time period (Margaret, George, 2011). Budgeting describes the overall process from preparing budget, using budgets during the business operation, and later performance evaluation. It provides us the valuable tools for planning and control of finances and affects nearly every type of organization-from governments and large corporations to small businesses-as well as families and individuals. A small business generally engages in budgeting to determine the most efficient and effective strategies for making money and expanding its asset base. Budgeting can help a company use its limited financial and human resources in a manner which best exploit existing business opportunities such production expansion and acquisition that might otherwise miss.

A good and through understanding of how budgeting works is a must for ambitious business executive if he or she wants to run the business with flying colors. What is more, budgeting give access to business owners who intend to assess the managers' performance during a specific time assigned. It is of great importance because the managers' compensation is quite often tied with his or her performance during the time in charge.

There are different kinds of budgets fall into various categories. The financial budget (Genrad, et al., 2002) includes the capital expenditure budget, which presents a company's plans for financing its operating and capital investment activities. The capital expenditure budget relates to purchases of plant, property, or equipment with a useful life of more than one year. On the other hand, the cash budget, the budgeted balance sheet, and the budgeted statement of cash flows deal with activities expected to end within the 12-month budget period. Last but not the least, companies' sales departments are often responsible of making sales budget based mainly on their products' selling experience last year and future economic conditions. The budget is developed within the framework of a sales forecast that shows potential sales for the industry and the company's expected sales.

Benefits of Budgets

With careful planning and good execution, a company can reap the benefits of having budgets in many ways, including:

Communication of corporate goals

Modern corporations consist of departments of different important functions. It is quite hard for the chief executive officer to convey the corporate goals to each employee very well. But on the other hand, in order for corporation to reach its best performance, it is indispensable for employees in different positions within a corporation to understand the corporate goals. The process of preparing budgets actually constructively bridges this communication gap because it engages everyone from managers to front-line staff. Quite often in practice, an CEO will hold a budgets discussion meeting that managers of various departments will come and discuss the company's whole budgets and make adjustments according to next year's goal. In this way, budgeting comes a communication tool because the different departments get the chance to take part in future planning and discuss the priorities for where the money and resources should be most suitably spent and allocated. More importantly, the act of making estimates about future economic conditions and about the company's ability to respond to them, forces managers to synthesize the external economic environment with their internal goals and objectives. This whole " communication process" is extremely crucial given the consideration of the complexity of business in recent years.

Warning of potential problems

Keeping budgets and constantly comparing it with the running of the real operating acts as an early warning system of potential problems which the management people in charge can make changes before things get out of control which make the company suffer greatly in terms of money and resources. In this way, when a flag is raised, managers in charge can revise their immediate plans such as to change a product mix, revamp an advertising campaign, or borrow money to cover cash shortfalls.

Coordination of different segments

Having the different departments within the corporation to create budgeting together is the key to resolving the differences and conflicts between various departments when involves in money and resources handling. Often in practice, the chief executive officer asks departments of various functions to make their own department budgets first according to each department's needs and its specific goal next year. Throughout this process, each department correlates each segment’s goals with corporate objectives. Preparation of a budget assumes the inclusion and coordination of the activities of the various segments within a business. The budgeting process demonstrates to managers the inter-connectedness of their activities and offers them directions to follow.

Evaluation of actual performance

The budget provides definite objectives for evaluating performance at each level of responsibility assigned (Jan, et al., 2008). Managers in charge are able to have access to do quick and easy performance evaluations with previous established criteria. With the economic conditions rapidly changing, managers may increase activities in one area where results are well beyond their exceptions. In situation like this, budgeting maximizes the objectivity to a great extent and offers a helpful hand for managers in making sound judgments with some indicators to compare. In other situations, managers may need to refer some measurement to reorganize activities whose outcomes demonstrate a consistent pattern of inefficiency, so that they can make timely adjustments to minimize the loss that otherwise might incur.

Problems of Budgets

As one of the most important steps in running a successful business, there is also some problems that involves with the budgets, including:

Overstating projections

Companies with strong ambitious of achieving success usually tend to think that their business will do a huge amount of business in a short amount of time which sometimes could be not very realistic in practice. So in this case, they often inflate the budgeted sales figure with possibly wrong sales forecasts. The overstating sales projections resulted from over optimistic future sales predictions most of the time will lead to other financial budgets such as cash flow budget, income statement budget, and balance sheet budget not reflecting the reality.

Lack of fairness in funds allocation

When asked to their own budget, different departments often have a tendency to ask more than they need to provide buffer in case unforeseen things that might happen in the future, so that they will not be under budget. This tendency prevent the funds to be allocated to the company's best interest and distorts the real needs and makes the next year funds allocation somehow lack of the fairness it should have, especially for corporations which is at the growing stage when the funds is extremely precious and limited. What is worse, when it comes to the using the budgets, the majority of departments will tend to squeeze the use of the budget at the beginning of the period to save for the later use, while try everything they can to use up the rest of the budget by the end of the period. This lack of consistency in usage actually further wastes the company's resources and money, which is likely lead to inconsistency of the goods and services that the company provides.

Lack of operation flexibility

While sticking to the budgets provides a roadmap for the running of operation, it can hinder creativity and flexibility of the company's development (Eugene, Michael, 2010). This situation arise often enough the managers cautiously and strictly enforce the operation in accordance with the budgets and give up some opportunity that might open doors to developing innovative products and exploring new markets. This is particularly true for those giant corporations where the managers are more willing to play it safe than taste a new flavor and usually lead them to only look at an annual plan therefore may fail to take a longer term view into account.

Behavioral aspects of Budgeting

Budgetary control relies greatly on the individuals of a corporation. The human aspect in the budgetary system can be very complicated since the budgetary process involves relationships between different people within the corporation which includes the chief executive officer, managers and staff. Some times budgets affect people's behaviors and vice versa. Thus the behavioral aspects of budgeting are of vital significance and consist of many different areas that high attention must be paid.

First and foremost, we need to know the Factors affecting behavior of budgeting, including:

Budgets perceived by employees as being too difficult

In situations that lack full participation of all levels in preparing for the budgets, the employees will perceive the budgets as being too difficult to follow. In addition, the punishment that comes along from failing to meet what this budgeted has a tendency to encourage staff's attempts to beat the system. This greatly affects the employees' enthusiasm for the job and can knock down their creativity and initiative which might lead to financial and nonfinancial loss for the corporation. In order to deal with this kind of situation, the managers in charge should maintain supportive and cooperative relationships with staff of all levels since it can leads to increase productivity and satisfaction which in turn can raise the working morale of staff. What is more, managers should try their best to make communication open without obstruction, which is extremely critical because the good communication in budgeting can act as a good delivery of corporate goals.

Targets that do not provide any challenge

In sharp contrast to the previous situation discussed just now, non-scientific and not reasonable budgeting could also result in having targets that do not provide any challenge which leads to no breakthroughs and developments. This happens more often than not when managers only emphasize on the financial goals which is quite detrimental to the realization of important non-financial goals. In order to fix this problem, managers should use the historical data as an important reference and try their best to gain a better understanding of the directions that the future economic conditions. Moreover, it is also of crucial importance for managers to identify the employee's ability objectively and truly engage the staff in participation genuinely. Due to a tendency for individuals to become " ego" involved in decisions which they have contributed, only in this way, can the budgeted goal be set in a way that reflect the real conditions and performs guidance.

Insufficient flexibility

There are times when strong-minded managers strictly hold on to budgets and overlook the real actual operation performance. Confronted with this kind of situation, what a company should do is to adopt variance analysis in practice. It is encouraged for businesses regularly conduct variance analysis because this allows them to notice if financial plans are inaccurate and therefore make timely adjustments. On the other hand, if businesses fail to analyse variances on a regular basis they will not be aware of their financial performance compared to what is budgeted. Favorable variance is when revenues are greater than budgeted or costs are less than budgeted. In contrary, adverse variance is when revenues are less than budgeted or costs are greater than budgeted. By calculating variances through looking at costs and revenues, managers can make wise remedies to cope with the situation and keep the company running on the right track.

Conclusion

Budgeting is a very crucial process that can bring numerous benefits to the companies if be used wisely and correctly. These benefits includes: Communication of corporate goals, Warning of potential problems, Coordination of different segments, and Evaluation of actual performance. All of them will increase the management's ability to more efficiently and effectively deploy resources, and to introduce modifications to the plan in a timely manner. However, there are also problems of that might incur when the budgeting is not proper done. These problems includes: Overstating projections, Lack of fairness in funds allocation, and Lack of operation flexibility. In order to truly embrace the benefits of budgeting, managers really should study the behavioral aspects of budgeting.