

An in-depth Discussion of Budget

Haoran Wen

School of Accounting (MPAcc Education Center), Shanxi University of Finance and Economics, Taiyuan
030006, China

18834189032@163.com

Keywords: budget theory, budget method, the learning effect

Abstract: This paper gives an in-depth discussion aiming at helping company to manage budget better. As we know, making budgets is very important towards a company, in this process, the company needs to use kinds of informations and different methods to set a suitable budget. A good budget can help company to forecast future financial transaction data and use the variance analysis to evaluate the manager's performance. This paper will discuss some relevant budget methods and theories to help company make a better budget management.

1. Introduction

As we know, setting targets is very important in any of company, so I want to choose this topic to talk about some ideas. I hope through my introduction and expound, the company can grasp and use relevant budget method and get some helps to make them to set budget better.

2. General introduction of budgeting

2.1 Definition

The budget means that the entity needs to prepare a quantitative plan for a specific time period. This plan can be either short-term or long-term, the short-term plan can be called tactical planning and the long-term planning can be called strategic planning.

2.2 The types of budgeting

- Functional budgeting: is also called department budgeting, is the budgets for the various functions and department of an entity. For example, the production budgets, marketing budgets, sales budget, purchasing budget all belong to the functional budgeting.

- Master budgeting: this is associated with the financial statements, such as the budgeted statement of comprehensive income, budgeted statement of financial position and cash flow budget.

2.3 Purpose of budgeting

Why a company needs to do budgets, the reason is as follow:

The different activities of an organization should help achieve goal congruence, a budget is a way of delegating responsibility within an organization, by showing managers which revenues and costs they are responsible for.

Having a budget will lead to better resource utilization and give managers a target in the form of a budget may improve their performance, in the year end, this is an important way to evaluate managers performance.

Have prepared budget in advance is also a communication method in a company, it represent the superiors communicate their expectations of the managers below them.

2.4 The drawback of budget

However, the budgeting also exists some problems:

If the budget is in an ideal standard, it is too difficult for employees to achieve, the budgets will lose the purpose of motivation. If the budget is in a lower standard, it is too easy to achieve, the company may not get progress, and the normal standard may encourage budget slack. So it is difficult to set the budget standard.

Individual managers seek to achieve their own objectives at the expense of the objectives of the organization, this will lead to dysfunctional behavior.

2.5 How to set a good budget

So the company need to think about how to set a good budget. An ideal target should be slightly above the anticipated level “challenge”.

First, should communicate in advance, when set the detail targets, should depend on controllable factors and can be quantified objectively. A good target should link to the reward so this can motivate the managers, it also needs to chosen to ensure goal congruence carefully.

In the process of setting budgets, the company will need use some relevant informations, including the finance and non-finance informations, short-term and long-term informations, internal and external informations and historical and future informations. For example, the company can depend on previous year’s actual results, some estimates, statistical and so on to set a good budget.

2.6 Budget control

Although the company had set the budgets, the company also needs to do some control and monitor on targets. The controls include two main controls, one is feedback control, and another is feedforward control.

- Feedback control: this control belongs to the after-event control, including negative feedback and positive feedback. The negative feedback indicates that results are deviating from the plan, and the positive feedback indicate that the results are going according to plan.

- Feedforward control: this control is control based on forecast results, if the forecast is bad, then control action is taken in advance. This control can encourage managers to be proactive and can prevent errors in advance. However, this control method will consume time than feedback control and need a sophisticated forecasting system.

3. Approaches to budgeting

3.1 Participation in setting targets

Top-down method

This method is also called imposed budgeting, the budget prepared by senior manager and being posted to individual managers, no participation of junior manager. The method is quick and easy and the budget has high quality, the budget will fit the corporate strategy. But this method will have poor motivation.

Bottom-up method

This method is called participative budgeting, the budget prepared by lower level management, and submit to higher level for approval. This method will promote the senior management can focus on more strategic things, the junior managers can have higher motivation and better communication, however, this method will consume many time and cost, may have poor quality and the budget slack can be incorporated.

3.2 Periodic budgets

The budget is prepared for typically one year at a time, no alterations once the the budget has been set, it means no update. This budget is suitable for stable business where forecasting is easy and where tight control is not necessary.

3.3 Rolling budgets

This is a budget kept continuously up to date by adding another accounting period when the earliest accounting period has expired. This budget method aims to keep tight control and always have an accurate budget for the next 12 months. This method is suitable if accurate forecasts can not be made, or for any area of business that needs tight control.

Rolling budgets can reduce the element of uncertainty, because the managers have to regularly reassess the budget, so the planning and control will be based on a more recent plan, in a fast changing environment and the situation which the tight control is needed, the rolling method is very suitable.

This method also has some disadvantages, for example, effort and expense required to continuously update the budget, will not be good at cost saving target and may demotivate managers.

3.4 Incremental budgeting

Start with the previous period's budget or actual results and add or subtract an incremental amount to cover inflation and other known changes.

This method assuming that the historic figures are acceptable, only the increment needs to be justified, so this is a quickest and easiest method. This method can avoid 'reinventing the wheel' and is suitable for stable business.

The drawbacks of this method is that if the historic information has some errors, this will build in previous problems and the uneconomic activities and spending may be continued.

3.5 Zero based budgeting

The process of zero based budgeting starts from the basic premise that next year's budget is zero. Compared to other budget methods, zero based budgeting makes no assumptions: each year's budgets are compiled by assessing each potential activity from zero base. In this way, zero based budgeting should identify any budgetary slack and eliminate it, in contrast to incremental approach where it is likely to continue. This is a technique used to allocate resources more efficiently thus reducing waste and increasing efficiency and is suitable for where discretionary cost is high.

The zero based budgeting can identify and remove inefficient or obsolete operations, can examine the organization's operations, with the opposite with incremental method, this method emphasis on future needs not past actions and will result in a more efficient allocation of resources.

As a new budget method, zero based method may emphasis short-term benefits to detriment of longer-term goals. In this process, the time and cost can be required and for the exist employees, they may resist this new method.

When the company use the zero based method, the company can use the three-step approach:

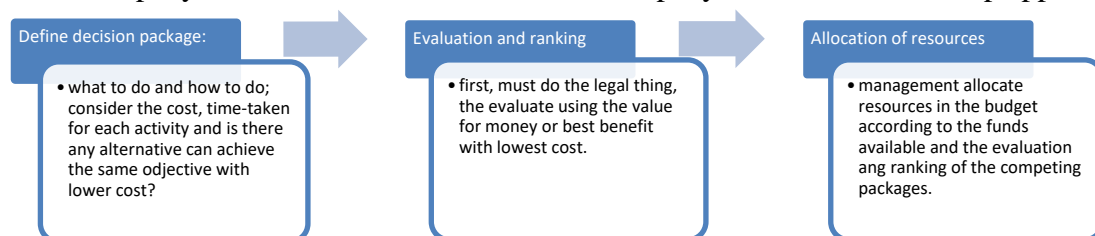


Figure 1. The three-step approach

Zero based budget is not particularly suitable for direct manufacturing costs. It is most commonly applied to service activities and departments.

This method is particularly useful in public sector organizations and local government. In the following situations, this method is better used:

- Where funding (income) is set and the best possible service for the available budget needs to be achieved.

- It is possible to segregate and assess the benefits of each activity, for example, hospital, schools, road maintenance.

- Where discretionary spending is high.

3.6 Activity based budgeting

This is a method of budgeting based on an activity framework and utilizing cost driver data in the budget-setting.

This method draws attention to the costs of overhead activities. Specifically, suitable to where overhead costs are a large proportion of total operation costs. At the same time, it provides information monitoring and controlling of activity costs.

However, this method will cost time and expense, it is difficult to clearly identify the responsibility for individual manager, sometimes, some cost may not be directly be driven by the level of activity, such as rent cost.

3.7 Beyond budgeting

Beyond budgeting is a budgeting model which proposes that traditional budgeting should be abandoned. Adaptive management processes should be used rather than fixed annual budgets.

4. Quantitative analysis in budgeting

In this part, let me focus on a quantitative analysis method-the learning curve.

As workers become more familiar with the production of a new product, average time and average cost per unit will decline. Repetition of task is likely to make the people more confident and knowledgeable and will eventually result in a more efficient and rapid operation. Eventually, the learning process will stop after continually repeating the job. So when the company sets budgets, it should consider the learning effect.

In learning curve theory, the cumulative average time per unit produced is assumed to decrease by a constant percentage every time total output of product doubles. The learning curve theory states that as cumulative output doubles, the cumulative average time taken per unit will fall to a given percentage of the previous cumulative production, this percentage is known as the the learning rate.

A formula for the learning curve is that $Y=ax^b$, this formula can be used to establish the average time or average cost per unit.

However, this method should use in following conditions:

- The activity is labour intensive.
- A repetitive process for each unit.
- Low turnover of labour force.
- Early stages of production.
- No prolonged breaks in production.

The learning effect indicate that as the employees gain experiences they are more likely to reduce material wastage. So when the steady stage is reached, a standard costing system would need to set. A budget will need to incorporate a learning cost factor until the steady state is reached, a budgetary control system incorporating labour variance will have to make allowance for the anticipated time changes.

However, this budget method will have some limitations. Firstly, it assumes the learning rate is constant, but in the real conditions, this will not come true. And the stable conditions necessary for the learning curve to take place may not be present. In this theory, the employees will more and more efficient and confident but the employees need to be motivated, agree to the plan and keep to the learning schedule, this assumption may not hold. In the formula, a, b these figures may be difficult to estimate.

5. Conclusion

Plan, budget and control are three significant elements in the operation of any company, so setting up a good budget is very important towards a company, a good budget can help company to better

forecast future event and better evaluate the manager's performance. To attain this target, the company should combine the learning effect theory and use some relevant budget methods to make a good budget and take on the continuous control.

References

- [1] Zhaowen Zhu, et al. 2015. Overall budget management.
- [2] Qianli, et al.2019. Key point of enterprise profit: overall budget management.
- [3] Jeffrey K. Pinto, et al. 2018. The project management.
- [4] Jiazuo, et al. 2015. Comprehensive budget management practice.
- [5] Anwar shah, et al. 2019. Budgeting and budgeting system.
- [6] Bliss in Cleveland, et al. 2014. Management economics and organizational structure.