# Budgeting

**# Understand the role of the finance department**

Just as individuals keep accounts, so do businesses. But for business, accounting is a necessity, not an option. Businesses must keep financial records on their past transactions for legal reasons. For example tax authorities can demand to see their accounts. Also, businesses need to plan for the future, so they need to be able to draw up financial forecasts to help them budget their income and expenditure.

Budgets are an important management (known as management accounting) 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.

**# Explain what is meant by a budget.**

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.

**Methods of Setting Budgets**

* **Historical** Base the budget on last year’s 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.

**# Explain the purpose of budgets.**

Budgeting is a management tool for controlling the business and effecting change. 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 firm’s 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.

**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.

**# Evaluate the use of Budgets to a business AND its stakeholders**

**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.

**Stakeholders**

#### External users of accounts

* Tax authorities
* Suppliers
* Bankers
* Investors and advisors
* The media
* Competitors
* The Community
* The Government

### Internal users of accounts

* Management
* Employees and their representatives.