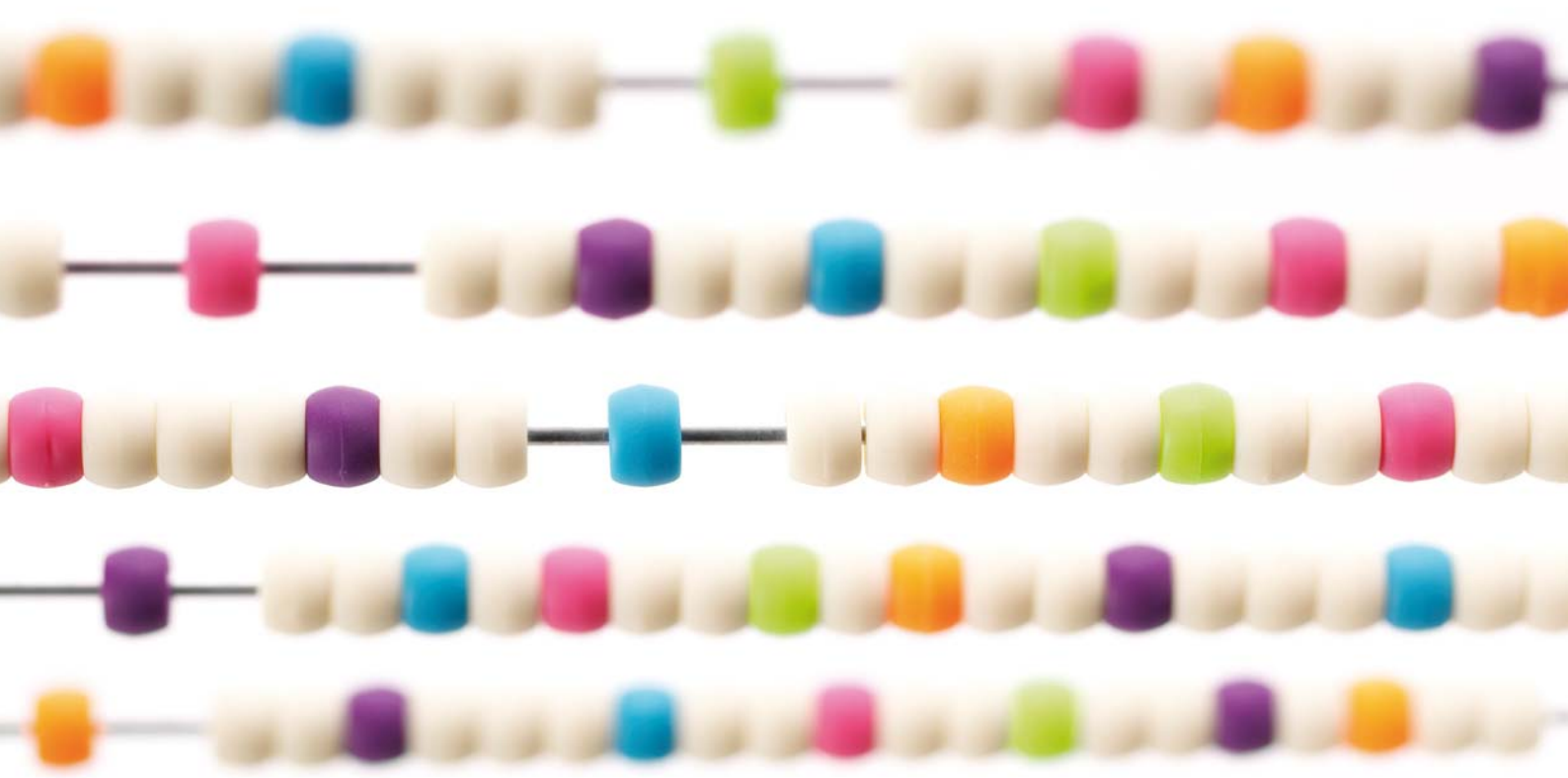


Budgeting

Topic Gateway Series No. 27



About Topic Gateways

Topic Gateways are intended as a refresher or introduction to topics of interest to CIMA members. They include a basic definition, a brief overview and a fuller explanation of practical application. Finally they signpost some further resources for detailed understanding and research.

Topic Gateways are available electronically to CIMA members only in the CPD Centre on the CIMA website, along with a number of electronic resources.

About the Technical Information Service

CIMA supports its members and students with its Technical Information Service (TIS) for their work and CPD needs.

Our information specialists and accounting specialists work closely together to identify or create authoritative resources to help members resolve their work related information needs. Additionally, our accounting specialists can help CIMA members and students with the interpretation of guidance on financial reporting, financial management and performance management, as defined in the *CIMA Official Terminology* 2005 edition.

CIMA members and students should sign into My CIMA to access these services and resources.

The Chartered Institute of Management Accountants

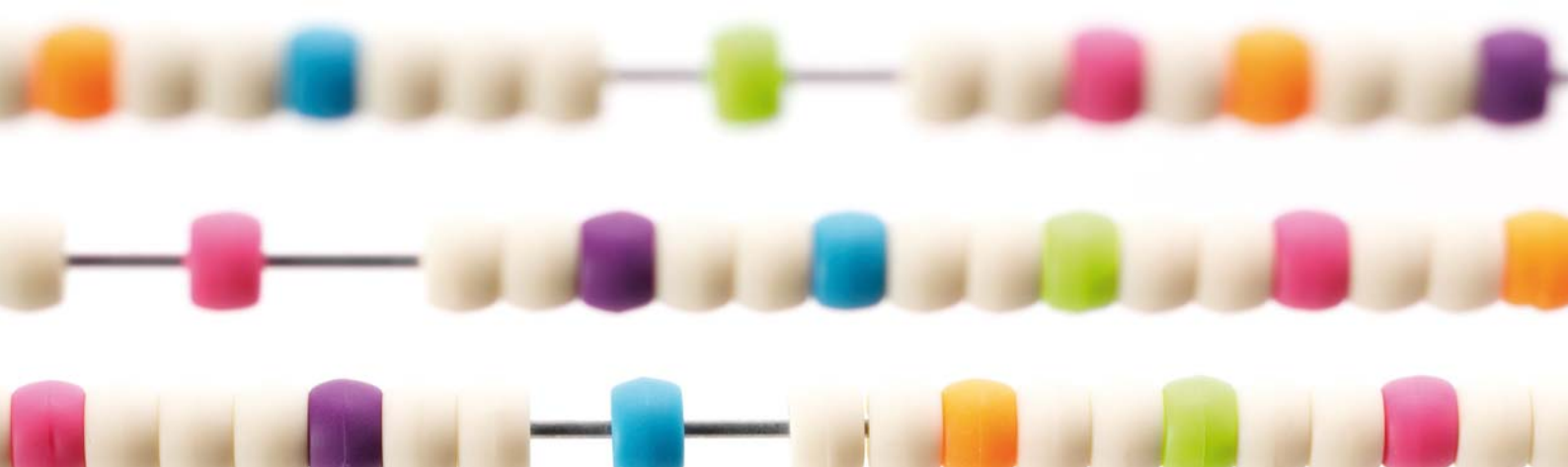
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Budgeting

Definition and concept

A budget is:

'A quantitative expression of a plan for a defined period of time. It may include planned sales volumes and revenues, resource quantities, costs and expenses, assets, liabilities and cash flows.'

CIMA Official Terminology, 2005

Budgeting practices are heavily influenced by the organisation's management style and can vary considerably, but the theory is common to all. Given the relationship between budgets and planning, readers might also like to refer to the Planning and Forecasting topic gateway. www.cimaglobal.com/mycima [Accessed 11 March 2008]

Context

In the current syllabus, CIMA students will learn and may be examined on the fundamentals of this topic in Certificate of Business Accounting 2006, Fundamentals of Management Accounting, Fundamentals of Business Mathematics and Fundamentals of Business Economics.

At professional qualification (managerial level), students will learn and may be examined on the management aspects of this topic in paper P1 Management Accounting Performance Evaluation, paper P2 Management Accounting Decision Management and paper P4 Organisational Management and Information Systems.

At Professional Qualification (Strategic level), students will learn and may be examined on the strategic aspects of this topic in paper P3 Management Accounting Risk and Control Strategy, paper P6 Management Accounting Business Strategy and paper P9 Management Accounting Financial Strategy.

Overview

Budgeting is the process of expressing the predicted costs and resources for a planned course of action over a specified time period. Budgets can be drawn up for business units, departments, products, teams or the entire organisation (see master budget below). Another term for a budget is a financial plan, but budgets can refer to non-cash resources, such as staff or time.

Budgeting helps all types of organisation to plan and control their operations, and to support their managerial strategies. A budget sets out the benchmark against which performance will be measured. For example, this might be the minimum profit and loss performance expected by senior management. Performance against budget may be part of the organisation's appraisal system for individuals who are deemed accountable for such performance.

Therefore budgets are a management tool, expressed in quantitative terms because this is the easiest way to prioritise and co-ordinate complex competing decisions throughout the organisation.

However, budgets may be dismissed as a 'finance' tool because they usually originate from the finance department and involve numbers. An unenlightened manager might undervalue their contribution. Budgets are often unpopular because of the time and effort spent on preparing and negotiating them, or explaining variances.

One school of thought believes that budgeting contributes to information overload, restricts management action and generally drains rather than contributes to the organisation. This has led to the development of alternative approaches to traditional budgeting.

In practice

The main purposes of budgeting relate to planning and control, and supporting the achievement of strategic plans by:

1. Translating the long-term plan into an annual work programme.
2. Co-ordinating the various departments of the organisation to ensure they are working in harmony. A budget requires managers to consider the relationship between their operations and those of other departments. Otherwise, managers might make decisions in their own interests, rather than the company's best interests.
3. Communicating plans to those who will be held accountable. Each department or individual should understand what role they play in helping the organisation achieve its plans. Key individuals are held accountable for the outcome of departments or teams, known as budget centres. A budget centre is:

'A section of an entity for which control may be exercised through prepared budgets. It is often a responsibility centre where the manager has authority over, and responsibility for, defined costs and (possibly) revenues.'

CIMA Official Terminology, 2005

In addition to the allocation of resources, budgeting also provides the authority for expenditure. It may be used to motivate staff by including performance against budget in the organisation's remuneration scheme.

Process

The budgeting process comprises:

1. Prioritisation of objectives identified in the planning process.
2. Assessment and quantification of total available resources, both financial and non-financial
3. Identification and quantification of the inputs and processes required to fulfil the stated objectives and the associated financial resource required. The role of each function and its significance in achieving the objectives should be taken into account. In setting budgets, consideration should be given to the inclusion of a non-allocated contingency element. This is so that reasonable allowance can be made for changes which cannot be reasonably anticipated in time or value.

4. Assignment of proportion(s) of the total resources necessary to acquire/manage inputs to achieve the stated objectives. Each dedicated proportion of the total resource constitutes a 'budget'.

Source: CIMA guide to devolved budgeting

Seasonal variations will be included so that the budget is as realistic as possible. The budget is fixed once it has been agreed – it is not changed during the period. This is to preserve its value as a fixed reference point. Changing circumstances or new information which affects the budget can be accommodated by budget flexing, or rolling budgets.

Rolling or continuous budget

A rolling or continuous budget is:

'A budget continuously updated by adding a further accounting period (month or quarter) when the earliest accounting period has expired. Its use is particularly beneficial where future costs and/or activities cannot be forecast accurately. See rolling forecast.'

CIMA Official Terminology 2005

Rolling forecasts are sometimes used instead of rolling budgets. You can read more about forecasting in the Planning and Forecasting Topic Gateway.

www.cimaglobal.com/mycima [Accessed 11 March 2008]

Budget flexing

Where there is a lot of uncertainty or volatility, it is possible to produce flexed budgets to anticipate performance at different levels of activity. The budget is still fixed, but it has some predefined and explained tolerance.

Budget flexing is defined as:

'Flexing variable costs from original budgeted levels to the allowances permitted for actual volume achieved while maintaining fixed costs at original budget levels.'

Variable cost allowance = $\frac{\text{ratio of actual volume achieved}}{\text{budget volume}} \times \text{original budget variable cost.}$

CIMA Official Terminology 2005

Different types of budget

There are several different types of budget, depending on their purpose, and they fit together in a cascade.

Master budget. At the top of the cascade is the master budget, a suite of statements with strong similarity to the published financial accounts. This budget consolidates all subsidiary budgets and usually comprises the budgeted profit and loss account, balance sheet and cash flow statement.

Senior management performance is often considered in relation to its effect on the balance sheet P&L or other financial information which is reported externally to investors and analysts.

Cash budget. This is a detailed budget of estimated cash inflows and outflows incorporating both revenue and capital items.

Capital budgeting. This is a process concerned with decision making in respect of specific investment project choices and the total amount of capital expenditure to commit.

Operating budget. This is the budget of the revenue and expenses expected in a forthcoming period.

Budgets can include financial indicators such as cash, profit/loss, working capital and non-financial items such as staff numbers, orders and volumes of output. Progress is monitored regularly (typically monthly) by comparing actual performance against budget. Here budget holders explain significant favourable or unfavourable variances. Budget variance is described as:

'The difference, for each cost or revenue element in a budget, between the budgeted amount and the actual cost or revenue. Where flexible budgeting is employed, it is the difference between the flexed budget and the actual value.'

CIMA Official Terminology 2005

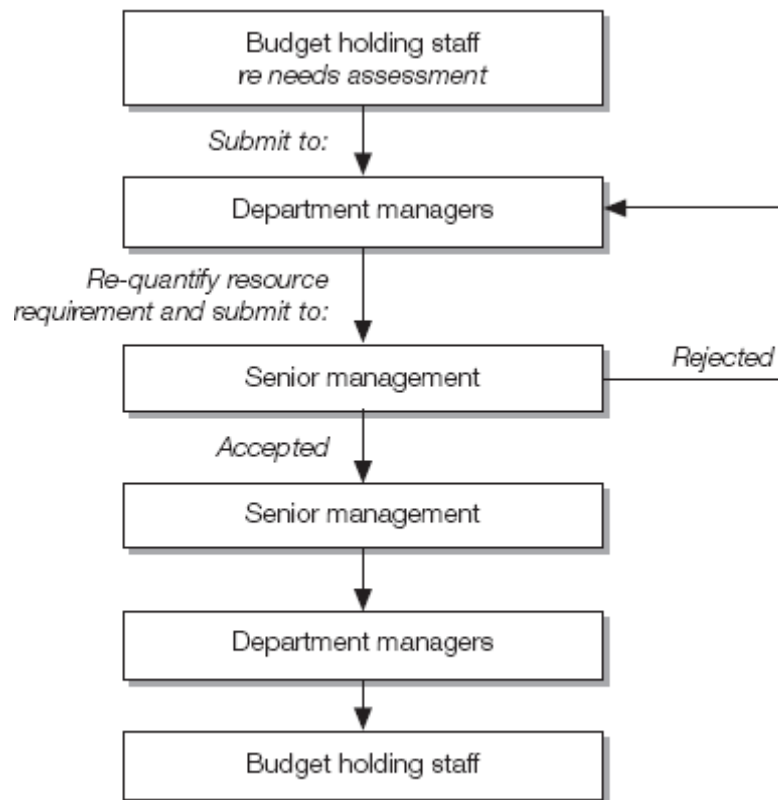
In terms of managerial or control issues, budgets may be:

1. 'Top-down' (imposed).
2. 'Bottom-up' (or participative) budgets.
3. 'Parallel' (or negotiated) budgets.

'Top-down' budgeting

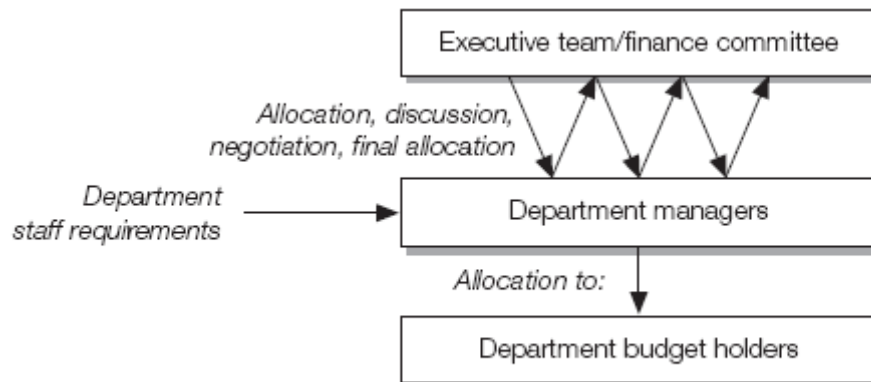


'Bottom-up' budgeting



Adapted from the *CIMA guide to devolved budgeting, 1997*

Negotiated budgeting



Adapted from the *CIMA Guide to Devolved Budgeting, 1997*

Drawbacks of budgeting

The drawbacks of budgeting have been identified as:

Inflexibility

- Budgets are time-consuming and costly to put together.
- Budgets constrain responsiveness and flexibility and are often a barrier to change.
- Budgets are rarely strategically focused and are often contradictory.
- Add little value, especially given the time required to prepare them.
- Concentrate on cost reduction and not on value creation.
- Strengthen vertical command and control.
- Do not reflect the emerging network structures that organisations are adopting.
- Encourage 'gaming' and perverse behaviours.
- Are developed and updated too infrequently, usually annually.
- Are based on unsupported assumptions and guesswork.
- Reinforce departmental barriers rather than encourage knowledge sharing.
- Make people feel undervalued.

Source: Cranfield/Accenture *Review of Budgeting Practices*, cited in Better Budgeting Forum

The most common method of preparing budgets is to prepare standalone Excel spreadsheets. Almost 80% of organisations do this, according to a 2003 survey of business planning and budgeting practices (see full text article below). This has many inherent problems, including:

- onerous and error-prone data entry – data is not transferred automatically from CPM or accounting systems
- convoluted or opaque formulae – so that the consequences of changing information in one cell are not obvious. This causes users to 'check' totals or calculations manually
- structural issues – frequently, the categories used by the budget holder don't correspond exactly with the nominal codes in the chart of accounts.

The implications of poor spreadsheet practices are significant. The usefulness of a budget as a benchmark for performance is undermined if it is inaccurate. Its role as a robust financial control is similarly invalidated if the spreadsheets underlying the budget are littered with untraceable and anonymous amendments.

Some critics argue that standalone spreadsheets have had their day. Although they may have contributed greatly to the efficiency of finance departments over the past two decades, standalone spreadsheets are not suited for today's enterprise wide planning. As an alternative, such critics advise the use of dedicated software of which there are many examples.

There are other, more general, drawbacks to budgeting. The results of a 2006 CFO Research Services survey are typical of many views (see full text article below). This reports that 45% of respondents felt that traditional budgeting was contentious and political, 72% felt it generated unrealistic numbers and just over half felt that it made managers behave badly.

Some pursue improvements to the techniques. Their view is that 'budgets are increasingly used to contribute directly to value creation. They inform strategy implementation, risk management and resource allocation, and are generally regarded as an integral part of running a business.' (Source: Better Budgeting Forum).

Alternatives

Over the past decade, alternative approaches to traditional budgeting have been debated and sometimes trialled. These include better budgeting, advanced budgeting and beyond budgeting. The percentage of respondents who used various alternatives was reported in the CFO Research Services survey cited previously:

	%
Rolling forecast	48
Last year plus percentage	45
Bottom up	41
Activity based budgeting	30
Zero based budgeting	26
Demand pull	16

Activity based budgeting

This method of budgeting is based on an activity framework. It uses cost driver data in the budget setting and variance feedback processes.

Zero based budgeting

This method of budgeting requires all costs to be specifically justified by the benefits expected. It is an alternative to incremental budgeting, where the budget is based on the previous period's budget or on actual results, and contains an uplift for inflation or other known changes.

Rolling (or continuous) budget

Here the budget is continuously updated by adding a further accounting period (month or quarter) when the earliest accounting period has expired. Its use is particularly beneficial where future costs and/or activities cannot be forecast accurately.

The purist position is occupied by beyond budgeting, a movement which believes organisations can manage without budgets. In practice, only one company (the Nordic banking group Handelsbanken) seems to have achieved this extreme.

The Balanced Scorecard, an approach which combines non-financial and financial control measures is widely used and has been postulated as an alternative to budgets.

Case studies

Beyond budgeting case study 1: the private company. Prickett, Ruth, Financial Management, November 2003, p. 24. Discusses the budget process at Bulmers, a UK cider manufacturer, and the changes proposed to improve that process.

Beyond budgeting case study 2: the charity. Prickett, Ruth, Financial Management, November 2003, p. 25. Considers the budgeting process at Sight Savers International, a UK based charity dedicated to combating blindness in developing countries.

Philadelphia Insurance Companies. *Insurance and Technology*, August 2004, Volume 29, Issue 8, p. 18. Looks at the implementation of a real-time budgeting application to address the problems of inconsistency and delays caused by their current decentralised and fragmented budgeting systems.

Texan City Council. *US Public Management*, May 2002, Volume 84, Issue 4, pp 16-18, 3 p. Considers the strategic planning process, the relationship between the strategic plan and the budget, the implementation of the strategic plan and lessons learnt.

Further Information

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Kugel, R. *Improving budgeting and planning: it's about more than saving time.* Business Finance, June 2004 Supplement, Volume 10, pp 11-15

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Books

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Maitland, I. (2000). *Budgeting for non-financial managers: how to master and maintain effective budgets.* London: Prentice Hall

Rasmussen, N. et al. (2003). *Process improvement for effective budgeting and financial reporting.* Hoboken, NJ: Wiley

CIMA Mastercourses

Better budgeting and forecasting. To book via www.cimamastercourses.com please go to Find and key in the course code BBUD.

Implementing driver-based budgeting and rolling re-forecasts. To book via www.cimamastercourses.com please go to Find and key in the course code IDBB.

Spreadsheet skills for forecasting, planning and budgeting. To book via www.cimamastercourses.com please go to Find and key in the course code SFPB.

Reading list

Bibliography planning and budgeting. Available from: www.cimaglobal.com/mycima
[Accessed 11 March 2008]

Website

Excel User

This is a website for business users of Excel. It aims to promote a product Enterprise Excel but does include some interesting discussion and links. One specific article is titled: *Is Excel budgeting a mistake?*

www.exceluser.com/bi/mistake.htm

[Accessed 11 March 2008]

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