

ALTERNATIVE APPROACHES TO BUDGETING

Drury Chapter 16 / B and K Chapter 17

Rolling Budgets

In some businesses it is not feasible to plan for up to a year ahead because of seasonality of the trade or because appreciable changes in that period are quite likely, possibly due to inflation. In such circumstances a rolling budget is more realistic for actual figures to be compared with. If an annual budget is prepared from January to December then for the first few months this is used, but then as time progresses another budget is prepared for perhaps April to March. This latter budget will update the last nine months of the existing budget and plan ahead for a further three months. The frequency with which the budget is rolled over depends on the planning horizon of the business and the pace of the changes (inflation).

Zero Based Budgeting

Quite frequently in practise, budgets are merely extrapolation of previous costs, e.g. last year's costs plus a percentage to allow for inflation, known as Incremental Budgeting. The problem with this approach is that it will still include the inefficiencies of the previous period and rarely will the relationship between costs, benefits and objectives be scrutinised. To overcome these problems various methods are used, one of which is Zero Based Budgeting. This is a cost-benefit approach, which assumes that the existing programmes are being launched for the first time. Each package within each programme is then ranked according to their cost-benefit (value for money). Once the base packages have been selected the other packages are chosen in order of cost-benefit until the budgeted spending level is reached.

Advantages of Zero Based Budgeting

1. It should improve the allocation of resources.
2. Communication within firm is increased.
3. Motivation should be increased.
4. Best methods of performing jobs should be used and new ideas should emerge.
5. Wastage and obsolete operations should be clearly identified and eliminated.
6. Coordination within the firm improves.
7. Particularly useful for service departments where it can be difficult to identify output.
8. Should help managers identify priorities.

Disadvantages of Zero Based Budgeting

1. Bad managers may feel threatened and may resist new ideas and changes.
2. It requires a vast number of decision packages in a large firm and hence tends to be expensive.
3. Some activities have qualitative rather than quantitative benefits.
4. The ranking of decision packages and the allocation of resources is subjective, which can result in departmental conflict.

Flexible Budgets

A fixed budget is one which is intended to remain unchanged irrespective of the volume of output or turnover actually attained. Such a budget is of little use as a control device when conditions change. A flexible budget recognises the difference in behaviour between fixed and variable costs, when output and turnover fluctuate and is designed to change in accordance with fluctuations in the level, etc. Flexible budgets can be used at the planning stage to cover the range of activity levels which may be experienced or used retrospectively at the end of each period to compare actual results achieved with the results that would have been expected if the actual circumstances had been known in advance. It is an important factor in budgetary control.

Example

An industrial cleaning company has gained a contract to clean in a hospital. The budget is drafted to plan the costs of cleaning 100,000 square feet of floor space. These costs, and the eventual actual costs, are shown below:

	Cost per sq. ft.	Fixed £	Variable £	Total £	Actual £	Variance £
Materials	25p	-	25,000	25,000	28,000	3,000 (A)
Labour	60p	-	60,000	60,000	69,000	9,000 (A)
Electricity	8p	1,000	8,000	9,000	9,500	500 (A)
Machine rental		8,000	-	8,000	9,000	1,000 (A)
Management		20,000	-	20,000	19,000	1,000 (F)
Maintenance	15p	2,000	15,000	17,000	17,000	-
		31,000	108,000	139,000	151,500	12,500 (A)

These figures appear disastrous for the manager until it is noted that 115,000 square feet were cleaned during the period. The fixed budget must be flexed to show the expected costs for the actual level of activity.

Flexible budget for 115,000 square feet						
	Cost per sq. ft.	Fixed £	Variable £	Total £	Actual £	Variance £
Materials						
Labour						
Electricity						
Machine rental						
Management						
Maintenance						

The comparison of like with like shows a different picture of the managerial performance. It has been suggested that since many cost items in modern industry are fixed costs the value of flexible budgets is dwindling. Flexible budgets are nevertheless necessary, and even if they are not used at the planning stage, they should be used for budgetary control variance analysis.

Activity based budgeting (ABB)

ABB is a planning and control system based on activity analysis techniques as used in ABC and stems from the technological change in the form of advanced manufacturing technology and the Just-in-time manufacturing philosophy.