



Prifysgol Cymru
Y Drindod Dewi Sant
University of Wales
Trinity Saint David

Management Accounting

(LCBB5002)

Assignment 1

THE ROLE OF BUDGETING IN HELPING MANAGERS MAKE OPTIMAL DECISIONS WITHIN A CONSTANTLY CHANGING ENVIRONMENT

Written by:
Aleksandar Nedev
1816234

For:
Dr. Rexon Nting

23.08.2020

Introduction

Regardless of their size, industry and complexity, enterprises heavily rely on budgets and budgetary systems in order to achieve their strategic goals. Budgeting is very important as it helps companies identify their goals, allocate responsibilities for the achievement of these goals, and consequently execute them (Shah 2007; Raghunandan et al 2012). In fact, it is considered one of the most successful and useful management accounting methods and if properly implemented firms can reap major rewards.

Today's business environment has become more volatile most especially because of a fast-changing technological environment characterised by constant innovations. This has made it essential for managers to incorporate budgeting systems in their strategic objectives in order to survive in the highly competitive environment (Kovaleva et al 2013). As noted by Horngren et al (2016), budgeting is essential in shifting planning, to the forefront of an organisation's management while limiting spending. In fact, the authors noted that the most successful and well-organised organisations have made budgeting an essential part of their strategic formulation and execution (Horngren et al 2016).

What is budgeting?

Shin and Siegel (2005) defined budgeting as a formal way of expressing an organisation's goals, plans and objectives which cover all operational details for a given period of time. Bocharov (2013) posited that budgeting symbolises an organisation's systems which involve the results of the planning processes, accounting, control and analysis of cost indicators of its activities while Horngren et al (2016) simply defines it as '*a process of formulating an organisation's plans*'. The different types of budgeting as noted by Shin and Siegel (2005) and Hornsgren et al (2016) include; the master budget, operating, financial, cash, static (fixed), flexible, capital expenditure, program, incremental, add on, supplement, bracket, target and continuous (rolling) budgets.

In the budgeting process, most organisations tend to focus on pricing, technological trends, manpower, new product innovation, production scheduling, resources, raw material cycles, inventory levels, turnover rate, financing needs, product or service obsolescence, reliability of input data, industry/ market stability, seasonality, advertising and marketing. But they ignore politics, the economy, change consumer tastes and needs, market share and competition, though they are also vital in today's volatile business environment (Shin and Siegel 2005).

The role of budgeting in helping managers make optimal decisions within a constantly changing environment

Budgets motivate managers to analyse what they have done as far as company goals are concerned in relation to what they *could* do (Barrett and Fraser III 1973; Dyson and Franklin 2017). Budgeting is very important because it helps managers in developing a company's production and financial activity plans, obliging managers to fore think by formalising their responsibilities for planning, helping them analyse current activities as well as likely new activities (Kovaleva et al 2013).

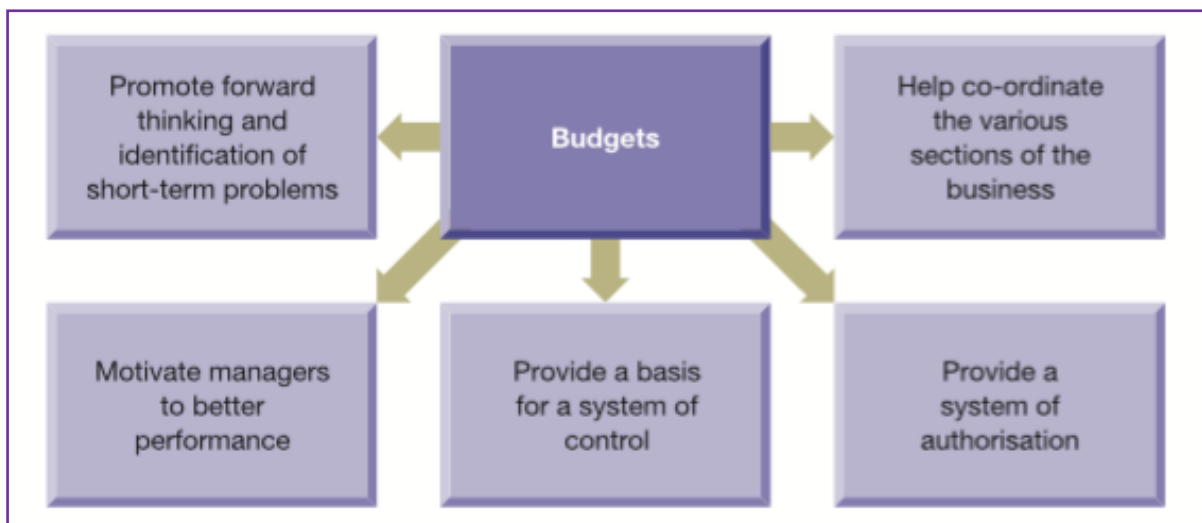
Budgeting is also essential in helping managers analyse organisation's subsequent performance as well as coordinating all actions across the organisation on top of communicating its objectives (Horngren et al 2016). It has also been identified as a vital tool in providing fundamental methods of controlling expenditure and income as well as helping policy makers in making good decisions while formulating plans and policies (Jones and Pendlebury 1992).

Companies utilise budgets for different roles including planning, evaluation and motivation, coordinating, communicating, instructing, performance measurement and authorising (Atrill and McLaney 2009). As planning tools, they offer managers with detailed lists of what they intend to accomplish and how. Planning is vital because it

forces managers to analyse details of the general economic situation as well as the economic interrelationships among the various business activities (Barret and Frazer III 1977; Northern Ireland Assembly 2010). This helps managers to investigate how costs and revenues will behave under given operating assumptions.

Through budgeting, management can both identify resources that will be necessary to achieve organisational objectives and learn how those resources must be applied.

Figure 1: Major benefits of budgets to companies



Source: Atrill and McLaney 2009.

Depending on different circumstances, companies can either undertake periodic or continual budgets. As noted by Atrill and McLaney (2009), periodic budgeting is normally set for a given period whereby managers come to an agreement and setup a specific budget for a given period and then let it run its course.

On the other hand, a continual budget is often updated, making it more flexible. Also referred to as rolling budgets, continual budgets are flexible in that the budget always adds a new month to replace the previous month. That way, there is always a budget for a full planning period (Atrill and McLaney 2009; Horngren et al 2016).

However, it should be noted that while continual budgets promote forward looking attitudes, they end up becoming a mechanical exercise in that managers may even

become too busy with other tasks to consider the company's future (Atrill and McLaney 2009). On the other hand, periodic budgeting consumes less time, effort and is less costly. But with time, the budget period becomes shorter and managers work to a shorter planning timeframe towards the end of the financial year.

Static vs flexible budgeting styles

One of the major decisions for budgeting management is whether to allow a company's budget to change over the course of a given period or remain the same. In this case, a budget that changes through the given period is a flexible budget while the one that does not change despite the changing environment is a static. Different companies develop their budgets depending on their performance expectations (Graybeal et al 2019).

Some scholars (e.g. Horngren et al 2013; Dyson and Franklin 2016) have referred to a static budget as a budget that is normally prepared for a single anticipated level of activity. It does not change or even flex for increases or decreases. Fixed budgets are most famous among relatively stable companies as well as the public sector because they are put in place for particular purposes with limited monetary resources (Shin and Siegel 2005; Northern Ireland Assembly 2010).

Shin and Siegel (2005) have further posited that fixed budgets are suitable for departments whose work-load is not directly related to sales, production, or some other volume determinant related to the company's operations. In a static budget, actual results at the end of the given period are compared to static budget numbers in order to evaluate the company's performance. In this case, there is a bigger chance of inaccurate results especially in cases where sales are different from what was originally budgeted.

This will not provide a clear picture of how the company is meeting its given targets (Graybeal et al 2019). Shin and Siegel (2005) argued that a static budget does not have flexibility to adapt to unpredictable changes, thus a major limitation in today's volatile

environment. On the other hand, flexible budgeting adjusts budget allowances according to the company's activities. This makes it possible for managers to make estimates of what budgeted numbers would appear depending on the level of sales (Graybeal et al 2019).

Unlike static budgets which are prepared in advance, Flexible budgets are prepared at each given period of analysis, allowing managers to compare the operating income to the expenses considered suitable at the actual production level. Flexible budgets tend to be more complicated, require total understanding of a company's fixed and variable expenses, but makes it possible for managers to hold greater control over changes that take place throughout the year.

A flexible budget makes it possible for managers to adjust their budgets depending on costs and revenues that occur from losses resulting from different factors in the environment (Aurelian 2015). The ability to change the budget depending on different variables makes it easier to point out responsible parties in case a revenue or cost target is missed (Graybeal et al 2019).

It should however be noted that though fixed budgets are easy to develop, considering that variable costs change with production and the fixed costs remain the same, planning to meet an organisation's goals can be very difficult if there are not many variable costs, if the cash inflows are relatively fixed, and if the fixed costs are high.

According to Graybeal et al (2019), the ability to offer flexible budgets is critical in new or changing businesses where the accuracy of estimating sales or usage may not be strong. Akten et al (2009) also posited that as the environment becomes more volatile and challenging, and economic forecasts change from week to week, developing one reliable budget to coordinate business units and track performance for an entire fiscal year is very difficult.

In fact, they claim that using the traditional budget has become unproductive. In this case, they advise companies to take measures such as Zero-based budgeting, scenario planning, rolling forecasts, as well as quarterly budgeting (Akten et al 2009). As noted by Henttu-Aho (2018), the planning function of budgeting is more vital in today's volatile business environments or a shaky economy, as organisations adapt to addressing the uncertainty by adapting to more frequent forecasts.

With all this put into perspective, a flexible budget is the most relevant in today's volatile business environment considering that managers can always adjust their budgets depending on costs and revenues that occur from losses resulting from different factors in the environment. However, Dyson and Franklin (2017) argued that benefits of a budgeting system only became apparent when it is used for *control* purposes. This includes making a constant comparison between the actual results and the budgeted results, and then taking any necessary corrective action.

Conclusion

Budgeting is essential for managers because it promotes forward thinking, motivates them to perform better, coordinates the various business segments, provides an authorisation system and also provides a basis for systems control. As today's business environment becomes more volatile, developing one reliable budget to coordinate business units and track performance for an entire fiscal year is becoming close to impossible.

In conclusion, a flexible budget is the most relevant in today's volatile business environment considering that managers can always adjust their budgets depending on costs and revenues that occur from losses resulting from different factors in the environment.

Reference list

- Akten, M., Giordano, M., and Scheiffele, M, A. (2009) "Just-in-time budgeting for a volatile economy" McKinsey & Company [Online] at <https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/just-in-time-budgeting-for-a-volatile-economy> Atrill, P. and McLaney, E. (2009) "Management Accounting for Decision Makers" 6th ed., Pearson Academic.
- Aurelian Constantin (2015) "Using Flexible Budgets To Manage Organizational Performance and Cost" Annals of the Academy of Romanian Scientists, New Series on Economy, Law and Sociology. Volume 1, Number 1 [Online] at https://www.researchgate.net/publication/334883135_USING_FLEXIBLE_BUDGETS_TO_MANAGE_ORGANIZATIONAL_PERFORMANCE_AND_COST
- Barrett, M, E. and Fraser III, L, B. (1977) "Budgeting: Conflicting Roles in Budgeting for Operations" Harvard Business Review [Online] at <https://hbr.org/1977/07/conflicting-roles-in-budgeting-for-operations>
- Bocharov, V.V. (2013). Financial planning and budgeting.St. Petersburg: Publishing house of St.Petersburg University, 90.
- Dyson, J, R. and Franklin, E. (2017) "Accounting for Non-Accounting Students." Ninth Edition, Pearson.
- Graybeal, P., Franklin, M., and Cooper, D. (2019) "Principles of Accounting" Volume 2; Managerial Accounting, 12th Media Services.
- Henttu-Aho Tiina (2018) " The role of rolling forecasting in budgetary control systems: reactive and proactive types of planning" Journal of Management Control volume 29, pages327–360(2018)

Horngren, C, T., Sundem, G, L., Burgstahler, D., and Schatzberg, J. (2013) "Introduction to Management Accounting."Sixteenth Edition, Pearson.

Jones, R. and Pendlebury, M. (1992) "Public Sector Accounting" 3rd Edition, Pitman Publishing, London.

Kovalevaa, T, M., Khvostenkoa, O, A., Glukhovaa, A, G., Nikeryasova, V, V., and Gavrilovc, D, E. (2016) "The Budgeting Mechanism in Development Companies"International Journal Of Environmental & Science Education, VOL. 11, NO. 15, 7726-7744.

Mariana, R. & George C, G. (2015) "The Flexible Budget– Basic Tool Of The Management Control In The Economic Entities," Scientific Bulletin - Economic Sciences, University of Pitesti, vol. 14(1), pages 3-10.

Northern Ireland Assembly (2010) "Methods of Budgeting" Research Paper 6/10, Research and Library Services [Online] at <http://www.focusintl.com/RBM150-0610.pdf>

Raghunandan, M., Ramgulam, N., and Mohammed, K, R. (2012) "Examining the Behavioral Aspects of Budgeting with particular emphasis onPublic Sector/Service Budget" International Journal of Business and Social Science, Vol. 3 No. 14