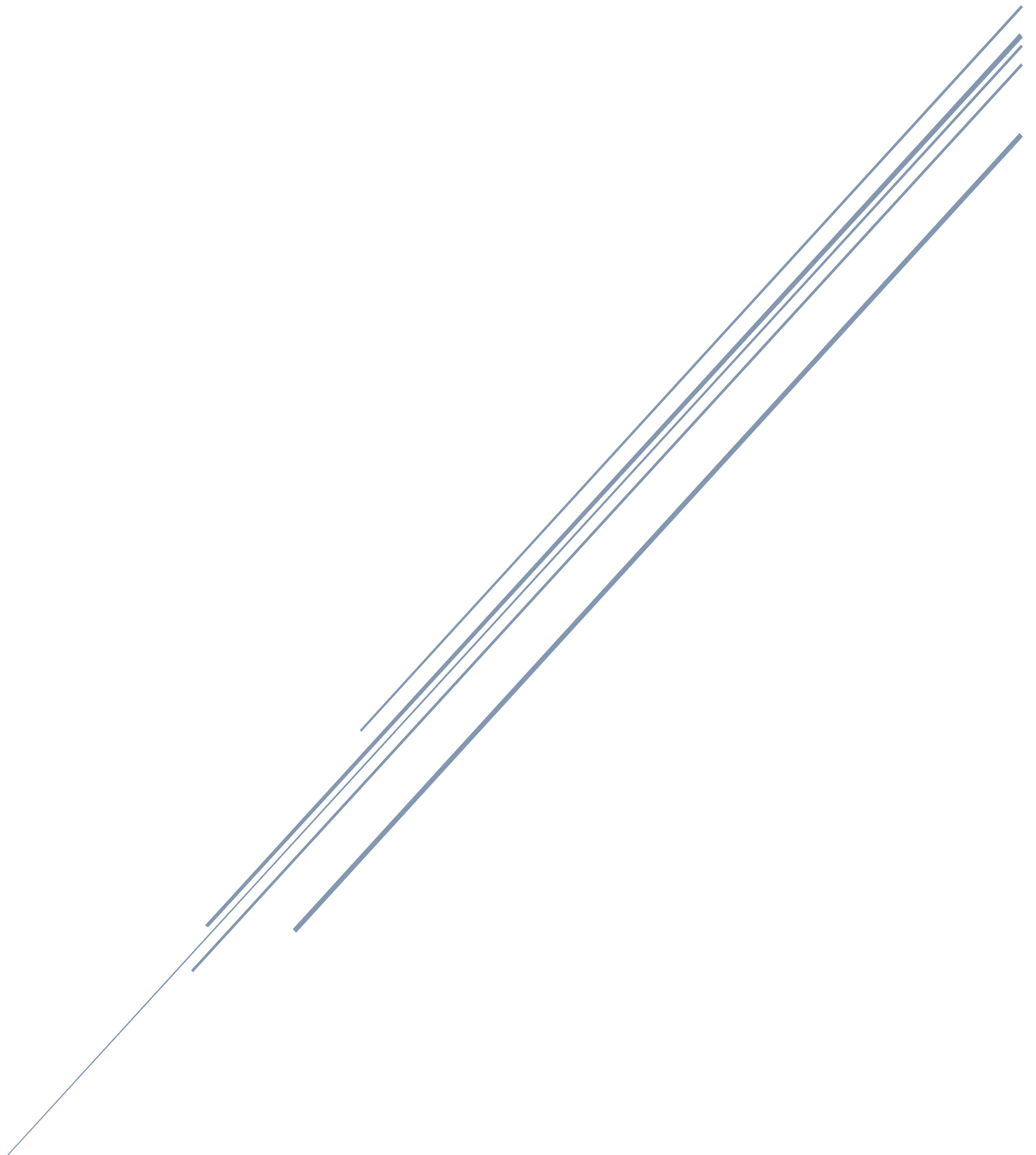


BUDGETING

MODULE TITLE: MANAGEMENT ACCOUNTING

MODULE CODE: LCBB5002

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Introduction

Risks and uncertainties are integral parts of modern organisations. To avoid these, planning holds critical importance within a business management context (Dunk, 2011). Specifically considering budgets, these are considered as the spending plans of the organisations (Frow, Marginson & Ogden 2010; Kobelsky et al., 2008). In other words, the budgeting exercise primarily helps a business organisation to plan and allocate its financial resources upfront considering the possible risks and business objectives (Melitski & Manoharan, 2014). Nonetheless, the effectiveness of a budgeting exercise would be typically dependent on the style and type of budgeting (Arnold, 2015). In this regard, the objective of this paper is to briefly review and discuss various types of budgeting. Besides, the discussion will critically assess the role of budgeting in helping managers for decision-making. Considering various types of budgeting, the suitable option for the business organisations will be presented to conclude the essay.

Role of budgeting in helping managers for decision making

Before considering the particular details of budgeting and its impact on the decision-making, it is imperative to have a brief overview of budgeting and its types. As demonstrated in the previous section of the paper, budgeting can be simply defined as the financial plan for a defined period within an organisation (Saunders & Cornett, 2014). In this spending plan, the organisation considers its expenses as well as income, while critically considering the historical performance and events to happen in the future (Horngren, Harrison & Oliver, 2012). As far as the types of budgeting are considered, this is classified on various grounds. For instance, based on the method of implementation, it is classified into static and flexible budgeting. Every budgeting exercise is based on a few assumptions, specifically about various internal and external factors on which the business has limited control (Hitt, Ireland & Hoskisson, 2012). In this regard, static budgets are the type of budgets that do not allow any change in the budget numbers with a change in these assumptions. For instance, if an organisation has allocated a certain budget for its marketing and the sale is continuously increasing while demanding additional marketing expenses, the static budgets might not allow any change in the expenses (Gitman & Zutter, 2015). On the other hand, flexible budgets have a provision to change the budget figures based on the changes in the external environment or any other factors that are assumed at the time of budget exercise. In terms of method of estimation, the budgeting exercise is also divided into either activity-based budgeting, zero-based budgeting, incremental budgeting, and value proposition (Saunders & Cornett, 2014). Briefly considering each of these, an activity-based budget considers the cost associated with each activity separately and estimates are prepared accordingly. On the

other hand, a zero-based budget is primarily built on an assumption that the cost of all sections within an organisation is zero and estimates must be prepared from scratch (Arnold, 2015). The incremental budgeting base the expenses and other numbers of budgets based on the historical data and an increment or decline is added on the top of that number to prepare the budget (Gitman & Zutter, 2015). Lastly, value-proposition consider the assumptions critically based on the value created by the customers. As highlighted in the literature, each type of budgeting has its consequences and effectiveness (Saunders & Cornett, 2014). Considering the situation of an organisation and the environment in which it operates, different types of budgeting can be used, which will help the managers to take effective decisions.

As far as the role of budgeting in helping managers to make optimal decisions, Eberlin and Tatum, (2008) argued that budgets are a roadmap for the management. This set a plan that will be the base of every execution activity within the organisation. For instance, an organisation has set a target of 40 per cent material cost in its budget. This will drive the management team to take initiatives and constantly monitor the material inputs to keep it aligned within the budget. In addition to this, it will also help the managers to take effective decisions for material purchases and price negotiations with the suppliers. Therefore, budgets provide help in decision-making as they set a clear road map of execution for the managers. Nonetheless, Lusardi, (2012) has a different narrative. According to the researchers, many organisations have linked the budgets with performance management of the managers. In this scenario, the budgets would certainly be a clear plan for the management, but it may also trigger dysfunctional behaviour within the managers (Hirshleifer, Jian & Zhang, 2018). For instance, to maintain their performance, the managers may overestimate the expenses at the time of budgeting. Other than this, the reporting and individual decisions of the managers may also be biased to represent fake performance against budget. Thus, the budgets, specifically when linked to the performance of the managers, may also result in dysfunctional behaviour of the managers.

As far as the effectiveness of budgets in making optimal decisions within the organisation is considered, the literature has different views of this. According to Nielsen, Mitchell and Nørreklit, (2015), highly dynamic and ever-changing markets of today have increased the uncertainties in the businesses. In this scenario, many organisations cannot foresee the situation to be observed in the future. Considering this, a fixed budget might not help make effective decisions. This is primarily because a fixed budget does not allow any changes in the initial estimates (Kidd, 2010). Thus, the type, as well as the style of budget, may have a critical role in taking an optimal decision within a changing market situation. In this regard, the consequence of different types of budgets has been reviewed in the following sections:

Evaluation of static and flexible budgeting

In the era of technology, an organisation has to adapt to the market situation and norms to ensure its competitiveness. In this situation, considering the effectiveness of static and flexible budgets, each may have its own merits and demerits. For instance, static budgets might be limited and inappropriate to adapt to the external environment and changing technology (Warren, Moffitt & Byrnes, 2015). However, according to He et al. (2010), this

type of budgeting helps to identify the variances from the initial estimates. A critical analysis of these variances may help the organisation to carry out changes in its strategic orientation, which will lead to organisational success. Nevertheless, Babalola and Abiola (2013) had shown disagreement with this and according to the researchers, the dynamic business environment of contemporary markets requires flexible budgets to quickly respond to the market situation. By adopting the option of static budget, an organisation limits itself to a defined line, without considering the changes in the environment or the strategy of its competitors (Fabozzi & Drake, 2011). Taking an example of Huawei, the company might have a substantial budget allocation for its product development. However, after a ban imposed by the American government on using Google services for its devices, the company had to allocate its extensive financial resources on the development of an alternative operating system (Lyu & Lee, 2019). The company responded quickly to the external situation using the flexible budgets and this has certainly helped the company to maintain its competitive advantage.

Participative budgeting and its merits/demerits

Aside from the static and flexible budget, the effectiveness of management decision-making is also dependent on the methodology through which budgets is developed. In this regard, two main methods are used including participative budgets and a top-down approach in which budget numbers are imposed over the middle management staff (Heinle, Ross & Saouma, 2014). In the participative budgeting, middle management has a notable role as they propose the financial plans and top management approves these plans. On the positive sides, this exercise helps to engage and motivate middle management (Gitman & Zutter, 2015). With this, they will have a high level of ownership and would promote better decision-making within the organisation. Also, the budget estimates in this particular case are likely to have more accuracy as the actual process owners present the estimate with an in-depth knowledge of their relevant area (Saunders & Cornett, 2014). Nonetheless, on negative sides, specifically, when top management does not have in-depth experience of the actual processes, this may result in incorrect estimation of budgets. The middle-management staff may overestimate or exaggerate the expenses to represent their improved performance against the budget (Kidd, 2010). Therefore, a participative budgeting exercise should be used only in the cases when top management can critically evaluate and assess the estimated based on the actual requirements.

Conclusion

Considering the analysis and views of different researchers, it is quite evident that budgets are imperative to ensure the survival of business in the dynamic and technology-driven environment of today. Nonetheless, as far as the optimal decision-making through budgeting is concerned, this is primarily dependent on style and type of budgeting exercise. A flexible budget might help the managers better to adapt with and to respond to the external environment of the business effectively and efficiently. In the case of static budgets, they may pull down the innovation capability and adaptability from the organisation, which are imperative to ensure business success in the modern markets of today. Thus, for the scenario, flexible budgeting would be a suitable choice. This can be

combined with the participative budgeting methodology. Nonetheless, for this to adopt, the top management must have relevant experience and in-depth knowledge of the operational areas and costs.

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