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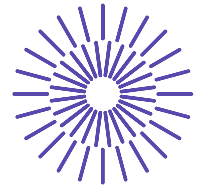

New Opportunities for the Development of Education at the Technical University of Liberec

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Learning Material for VM New Challenges for Management Accounting.

Chapter 8: The Budgeting Process.

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Chapter 8: The Budgeting Process

Learning objectives

1. Define a budget and show how budgets, strategic objectives and strategic plans are related.
2. Explain the budgeting process and the interlinking of the various budgets within the business.
3. Identify the uses of budgeting and construct various budgets, including the cash budget, from relevant data.
4. Discuss the criticisms that are made of budgeting.

Key words

activity-based budgeting (ABB), budget, cash budget, continual budget, discretionary budget, financial budget, forecast, incremental budgeting, investment centre, kaizen budgeting, master budget, periodic budget, pro forma statements, strategy, rolling budget, operating budget, operating cycle, organisational structure, profit centre, responsibility centre, responsibility accounting, rolling budget, zero-based budgeting (ZBB)

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8.1 The Link of Budgets with Strategic Plans and Objectives

It is vital that businesses develop plans for the future. Whatever a business is trying to achieve, it is unlikely to happen unless its managers are clear what the future direction of the business is going to be.

The development of plans involves five key steps:

1. **Establish mission, vision and objectives**
   The mission and vision statements set out the overriding purpose of the business and what it seeks to achieve. The strategic objectives translate these into specific targets for the future and will be used as a basis for evaluating actual performance.

2. **Undertake a position analysis**
   This involves an assessment of where the business is currently placed in relation to where it wants to be, as set out in its mission, vision and strategic objectives.

3. **Identify and assess the strategic options**
   The business must explore the various ways in which it might move from where it is now (identified in Step 2) to where it wants to be (identified in Step 1).

4. **Select strategic options and formulate plans**
   This involves selecting what seems to be the best of the courses of action, or strategies, (identified in Step 3) and formulating a long-term strategic plan. This strategic plan is then normally broken down into a series of short-term plans, one for each aspect of the business. These plans are the budgets.

   Thus, **a budget** is a business plan for the short term – typically one year – and is expressed mainly in financial terms. Its role is to convert the strategic plans into actionable blueprints for the immediate future.

   Budgets will define precise targets concerning such things as:
   - cash receipts and payments;
   - sales volumes and revenues, broken down into amounts and prices for each of the products or services provided by the business;
   - detailed inventories' requirements;
   - detailed labour requirements; and
   - specific production requirements.

5. **Perform, review and control**
   Here the business pursues the budgets derived in Step 4. By comparing the actual outcome with the budgets, managers can see if things are going according to plan. Action must be taken to exercise control where actual performance does not match the budgets.

   Control can be defined as compelling events to conform to plan. This definition is valid in any context. In a business context, management accounting has an important role to play in the control process. This is because it is possible to state many plans in financial terms (as budgets). Since it is also possible to state

actual outcomes in the same terms, making comparison between actual and planned outcomes is a relatively simple matter. Where actual outcomes are at variance with budgets, this variance should be highlighted by financial information. Managers can then take steps to get the business back on track towards the achievement of the budgets.

The relationship between the mission, vision, strategic objectives, strategic plans and budgets can be summarised as follows:

- the **mission and vision** set the overall direction and, once set, this is likely to last for quite a long time – perhaps throughout the life of the business;
- the **strategic objectives**, which are also long-term, will translate the mission and vision into specific, often quantifiable, targets;
- the **strategic plans** identify how each objective will be pursued; and
- the **budgets** set out, in detail, the short-term plans and targets necessary to fulfil the strategic objectives.

Figure 8.1 shows the planning and control process in diagrammatic form.

Figure 8.1 The planning and control proces
Source: ATRILL, P. and E.J. McLANEY. Management accounting for decision makers

Once the **mission, vision and objectives** of the business have been determined, the various strategic options available must be considered and evaluated in order to derive a strategic plan.

The budget is a short-term financial plan for the business that is prepared within the framework of the strategic plan. Control can be exercised through the comparison of budgeted and actual performance. Where a significant divergence emerges, some form of corrective action should be taken. If the budget figures prove to be based on incorrect assumptions about the future, it might be necessary to revise the budget.

Setting strategic plans is typically a major exercise performed about every five years and budgets are usually set annually for the forthcoming year. These time horizons, however, may vary according to the needs of the particular business. Those businesses involved in certain industries – say, information technology – may feel that five years is too long a planning period since new developments can, and do, occur virtually overnight. Here, a planning horizon of two or three years may be more appropriate. Similarly, a budget need not be set for one year, although this appears to be a widely used time horizon.

An annual budget sets targets for the forthcoming year for all aspects of the business. It is usually broken down into **monthly budgets**, which define **monthly targets**. Indeed, in many instances, the annual budget will be built up from monthly figures. The sales staff, for example, may be required to set sales targets for each month of the budget period. These targets may well differ from month to month, particularly where there are seasonal demand variations. Other budgets will be set for each month, as we shall explain shortly. Though, undoubtedly, a year is the standard budgeting period, some would argue that this is too long.

8.2 Budgets and Forecasts

A budget may, as we have already seen, be defined as a business plan for the short term. Note particularly that **a budget is a plan, not a forecast**. To talk of a plan suggests an intention or determination to achieve the targets; forecasts tend to be predictions of the future state of the environment. Clearly, forecasts are very helpful to the planner/budget-setter. If, for example, a reputable forecaster has predicted the number of new cars to be purchased in the UK during next year, it will be valuable for a manager in a car manufacturing business to take this into account when setting next year's sales budgets. However, a forecast and a budget are distinctly different.

Budgeting can be undertaken on a periodic or a continual basis.

A periodic budget is pre-pared for a particular period (usually one year). Managers will agree the budget for the year and then allow the budget to run its course. Although it may be necessary to revise the budget on occasions, preparing the periodic budget is, in essence, a one-off exercise during each financial year.

A continual budget, as the name suggests, is continually updated. An annual budget will normally be broken down into smaller time intervals (usually monthly periods) to

help control the activities of the business. A continual budget will add a new month to replace the month that has just passed, thereby ensuring that, at all times, a budget for a full planning period is available. A continual budget is also referred to as **a rolling budget.**

Periodic budgeting will usually take less time and effort and will, therefore, be less costly. However, as time passes, the budget period shortens and towards the end of the financial year managers will be working to a very short planning period indeed. Continual budgeting, on the other hand, will ensure that managers always have a full year's budget to help them make decisions. It is claimed that continual budgeting ensures that managers plan throughout the year rather than just once each year. In this way it encourages a perpetual forward-looking attitude.

A typical larger business will prepare more than one budget for a particular period. Each budget prepared will relate to a specific aspect of its operations. The ideal situation is probably that there should be a separate operating budget for each person who is in a managerial position, no matter how junior. The contents of each of the individual operating budgets will be summarised in **master budgets**, usually consisting of a budgeted income statement and statement of financial position (balance sheet). **The cash budget** is considered by some to be a third master budget.

Figure 8.2 illustrates the interrelationship and interlinking of individual operating budgets, in this particular case using a manufacturing business as an example.

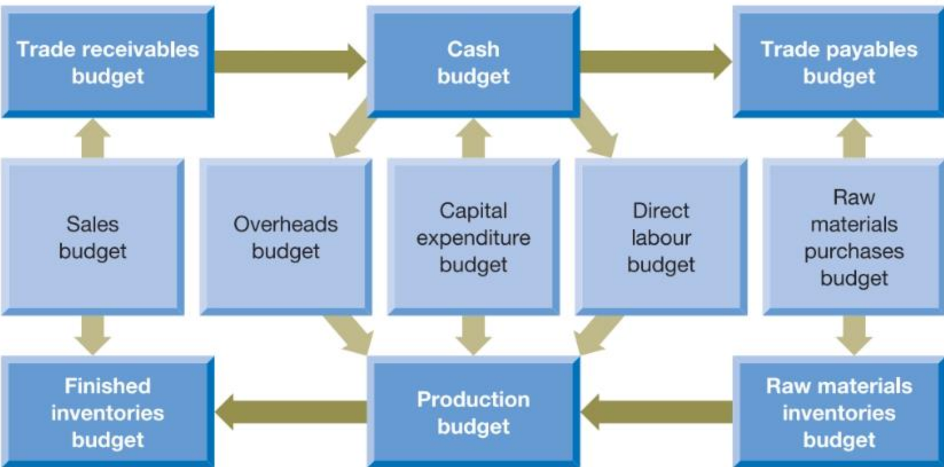

Figure 8.2 The interrelationship of operating budgets
Source: ATRILL, P. and E.J. McLANEY. Management accounting for decision makers

The starting point is usually **the sales budget**. The expected level of sales normally defines the overall level of activity for the business. The other **operating budgets** will be drawn up in accordance with this. Thus, the sales budget will largely define the finished inventories requirements and from this we can define the production requirements and so on. This shows the interrelationship of operating budgets for a manufacturing business.

Budgets are generally regarded as having five **areas of usefulness**. These are:

1. **Budgets promote forward thinking and the identification of short-term problems.**
   A shortage of production capacity might be identified during the budgeting process. Making this discovery in good time could leave open a number of ways of overcoming the problem. If the potential production problem is picked up early enough, other ways of overcoming the problem can be explored. Identifying the problem early gives managers time for calm and rational consideration of the best way of overcoming it. The best solution may only be feasible if action can be taken well in advance.

2. **Budgets can help co-ordination between the various sections of the business.**
   It is crucially important that the activities of the various departments and sections of the business are linked so that the activities of one are complementary to those of another. The activities of the purchasing/procurement department of a manufacturing business, for example, should dovetail with the raw materials needs of the production departments. If they do not, production could run out of raw materials, leading to expensive production stoppages or excessive amounts of raw materials could be bought, leading to large and unnecessary inventories holding costs.

3. **Budgets can motivate managers to better performance.**
   Having a stated task can motivate managers and staff in their performance. Simply telling managers to do their best is not very motivating, but setting a required level of achievement is more likely to be so. Managers will be better motivated by being able to relate their particular role to the business's overall objectives. Since budgets are directly derived from strategic objectives, budgeting makes this possible. It is not feasible to allow managers to operate in an unconstrained environment. Having to operate in a way that matches the goals of the business is a price of working in an effective business.

4. **Budgets can provide a basis for a system of control.**
   As we saw earlier in the chapter, control is concerned with ensuring that events conform to plans. If managers wish to con some yardstick against which to measure and assess it. Current performance might be compared with past performance or perhaps with what happens in another business. However, planned performance is usually the best yardstick. If there is information available concerning the actual performance for a period, and this can be compared with the planned performance, then a basis for control will have been established.

   There is an opportunity to use **management by exception**, an approach where senior managers can spend most of their time dealing with those staff or activities that have failed to achieve the budget (the exceptions). They do not have to spend too much time on those where actual performance conforms to plan. Effective budgets allow all managers to exercise self-control. By knowing what is expected of them and what they have actually achieved, they can assess how well they are performing and take steps to correct matters where they are failing to achieve.

5. **Budgets can provide a system of authorisation for managers to spend up to a particular limit.**
   Some activities (for example, staff development and research and development) are allocated a fixed amount of funds at the discretion of senior management. This provides the authority to spend.

8.3 Budget-Setting Process

Budgeting is such an important area for businesses, and other organisations, that it tends to be approached in a fairly methodical and formal way. This usually involves a number of steps.

Figure 8.3 Steps in the budget-setting process
Source: ATRILL, P. and E.J. McLANEY. Management accounting for decision makers

Step 1: Establish who will take responsibility

Those responsible for the budget-setting process must have real authority within the business.

A budget committee is usually formed to supervise and take responsibility for the budget-setting process. This committee usually includes a senior representative of most of the functional areas of the business – marketing, production, human resources and so on. Often, a budget officer is appointed to carry out the technical tasks of the committee, or to supervise others carrying them out. Not surprisingly, given their technical expertise, accountants are often given this role.

Step 2: Communicate budget guidelines to relevant managers

Budgets are intended to be the short-term plans that seek to work towards the achievement of strategic plans and to the overall objectives of the business. It is, therefore, important that, in drawing up budgets, managers are well aware of what the strategic plans are and how the forthcoming budget period is intended to work towards them. Managers also need to be made well aware of the commercial/economic environment in which they will be operating. This may include awareness of market trends, future rates of inflation, forecast changes in technology and so on. It is the budget committee's responsibility to see that managers have all the necessary information.

Step 3: Identify the key, or limiting, factor

There might be a limiting factor that will restrict the business from achieving its objectives to the maximum extent. Identifying the limiting factor at the earliest stage in the budget-setting process will be helpful.

Step 4: Prepare the budget for the area of the limiting factor

The limiting factor will determine the overall level of activity for the business. The limiting-factor budget will, as we have already seen, usually be the sales budget, since the ability to sell is normally the constraint on future growth.

Step 5: Prepare draft budgets for all other areas

The other budgets are prepared, consistent with the budget for the area of the limiting factor. In all budget preparation, the computer has become an indispensable tool. Much of the work of preparing budgets is repetitive and tedious, yet the resultant budget has to be a reliable representation of the plans made. Computers are ideally suited to such tasks and human beings are not. Budgets often have to be redrafted several times because of some minor alteration; computers do this without complaint.

Setting individual budgets may be approached in one of two broad ways:

- The **top-down approach** is where the senior management of each budget area originates the budget targets, perhaps discussing them with lower levels of management and, as a result, refining them before the final version is produced.
- With the **bottom-up approach**, the targets are fed upwards from the lowest level. For example, junior sales managers will be asked to set their own sales targets, which then become incorporated into the budgets of higher levels of management until the overall sales budget emerges.

The bottom-up approach allows greater involvement among managers in the budgeting process and this, in turn, may increase the level of commitment to the targets set. It also allows the business to draw more fully on the detailed knowledge and expertise of its man-agers. However, this can be time-consuming and may result in some managers setting themselves undemanding targets in order to have an easy life.

The top-down approach enables senior management to communicate plans to employees and to coordinate the activities of the business more easily. It may also help in establishing more demanding targets for managers. However, the level of commitment to the budget may be lower as many of those responsible for achieving the budgets will have been excluded from the budget-setting process.

Step 6: Review and co-ordinate budgets

The budget committee must, at this stage, review the various budgets and satisfy itself that the budgets are consistent with one another. Where there is a lack of co-ordination, steps must be taken to ensure that the budgets mesh. Since this will require that at least one budget must be revised, this activity normally benefits from a consensual approach. Ultimately, however, the committee may be forced to assert its authority and insist that alterations are made.

Step 7: Prepare the master budgets

The master budgets are the budgeted income statement and budgeted statement of financial position – and, perhaps, a summarised cash budget. The individual operating budgets, that have already been prepared, should provide all of the information required to prepare the master budgets. The budget committee usually undertakes the task of preparing the master budgets.

Step 8: Communicate the budgets to all interested parties

The formally agreed operating budgets are now passed to the individual managers who will be responsible for their implementation. This is, in effect, senior management communicating to the other managers the targets that are expected to be achieved.

Step 9: Monitor performance relative to the budget

Much of the budget-setting activity will have been pointless unless each manager's actual performance is compared with the benchmark of planned performance, which is embodied in the budget.

Where the established budgets are proving to be **unrealistic**, it is usually helpful to **revise** them. They may be proving to be unrealistic because certain assumptions made when the budgets were first set have turned out to be incorrect. This may occur where managers (budget setters) have made poor judgements or where the environment has changed unexpectedly from what was, quite reasonably, assumed. Unrealistic budgets are of little value and revising them may be the only logical approach to take. Nevertheless, revising budgets should be regarded as exceptional and only undertaken after careful consideration.

8.4 Incremental and Zero-Based Budgeting

Budget setting often seems to be done on the basis of what happened last year, with some adjustment for any changes in factors that are expected to affect the forthcoming budget period (for example, inflation). This approach is known **as incremental budgeting** and is often used for **discretionary budgets**, such as research and development and staff training. With this type of budget, the **budget holder** (the manager responsible for the budget) is allocated a sum of money to be spent in the area of activity concerned. Such budgets are referred to as 'discretionary' budgets because the sum allocated is normally at the discretion of senior management.

These budgets are very common in local and central government (and in other public bodies), but are also used in commercial businesses to cover the types of activity just referred to. Discretionary budgets are often found in areas where there is no clear relationship between inputs (resources applied) and outputs (benefits).

Zero-base budgeting (ZBB, also known as **priority-based budgeting**) rests on the philosophy that all spending needs to be justified. *Thus, when establishing, for example, the training budget each year, it is not automatically accepted that training courses should be financed in the future simply because they were undertaken this year. The training budget will start from a zero base (that is no resources at all) and will only be increased above zero if a good case can be made for the scarce resources of the business to be allocated to this form of activity. Top management will need to be convinced that the proposed activities represent 'value for money'.*

ZBB encourages managers to adopt a **more questioning approach** to their areas of responsibility. To justify the allocation of resources, managers are often forced to think carefully about the particular activities and the ways in which they are undertaken. This questioning approach should result in a more efficient use of business resources. With the increasing computerisation of production, including in the provision of services, there is a progressively larger portion of the total cost of most businesses in areas where the link between outputs and inputs is not always clear. The commitment of resources is, therefore, discretionary rather than demonstrably essential to production.

The principal **problems with ZBB** are:

- It is time-consuming and therefore expensive to undertake.
- It can lead to a concentration on cost cutting at the expense of seeing the wider picture.
- Managers whose sphere of responsibility is subjected to ZBB can feel threatened by it.

8.5 Preparing Budgets

It is helpful for us to start with the cash budget.

The cash budget is a key budget (some people see it as a 'master budget' along with the budgeted income statement and budgeted statement of financial position); most

economic aspects of a business are reflected in cash sooner or later. This means that, for a typical business, the cash budget reflects the whole business more comprehensively than any other single budget. A very small, unsophisticated business (for example, a corner shop) may feel that full-scale budgeting is not appropriate to its needs, but almost certainly it should prepare a cash budget as a minimum.

Since budgets are normally used only for internal purposes, their format is a matter of management choice and will vary from one business to the next. However, all managers, irrespective of the business, use budgets for similar purposes and so there is some consistency of approach. In most businesses, the cash budget will probably possess the following features:

1. The budget period would be broken down into sub-periods, typically months.
2. The budget would be in columnar form, with one column for each month.
3. Receipts of cash would be identified under various headings and a total for each month's receipts shown.
4. Payments of cash would be identified under various headings and a total for each month's payments shown.
5. The surplus of total cash receipts over payments, or of payments over receipts, for each month would be identified.
6. The running cash balance would be identified. This would be achieved by taking the balance at the end of the previous month and adjusting it for the surplus or deficit of receipts over payments for the current month.

Although each budget will have its own particular features, many will follow the same sort of pattern as the cash budget. That is, they will show inflows and outflows during each month and the opening and closing balances in each month.

Trade receivables budget would normally show the planned amount owed to the business by credit customers at the beginning and at the end of each month, the planned total credit sales revenue for each month and the planned total cash receipts from credit customers (trade receivables). The opening and closing balances represent the amount that the business plans to be owed (in total) by credit customers (trade receivables) at the beginning and end of each month, respectively.

Trade payables budget typically shows the planned amount owed to suppliers by the business at the beginning and at the end of each month, the planned credit purchases for each month and the planned total cash payments to trade payables. The opening and closing balances represent the amount planned to be owed (in total) by the business to suppliers (trade payables), at the beginning and end of each month respectively.

Inventories budget would normally show the planned amount of inventories to be held by the business at the beginning and at the end of each month, the planned total inventories purchases for each month and the planned total monthly inventories usage. The opening and closing balances represent the amount of inventories, at cost, planned to be held by the business at the beginning and end of each month respectively.

A raw materials inventories budget, for a manufacturing business, would follow a similar pattern, with the 'inventories usage' being the cost of the inventories put into production.

A finished inventories budget for a manufacturer would also be similar to the one shown above, except that 'inventories manufactured' would replace 'purchases'.

A manufacturing business would normally prepare both a raw materials inventories budget and a finished inventories budget. Both of these would typically be based on the full cost of the inventories (that is, including overheads). There is no reason, however, why the inventories should not be valued on a variable cost, or direct cost, basis if this would provide more useful information. The inventories budget will normally be expressed in financial terms, but may also be expressed in physical terms (for example, kilograms or metres) for individual inventories' items.

8.6 Activity-Based Budgeting

Activity-based budgeting (ABB) extends the principles of activity-based costing, which we discussed in Chapter 7, to the budgeting process. Under a system of ABB, the first step is usually to determine the sales budget. This is, of course, the same starting point as under conventional budgeting. The next step is to identify the activities needed to achieve the budgeted sales, along with their cost drivers. For each activity, a budgeted cost driver rate is established, which is then multiplied by the estimated usage of the cost driver (as determined by the sales budget). This final calculation provides the activity budget for the period. The various steps in the process are shown in diagrammatic form in Figure 8.4.

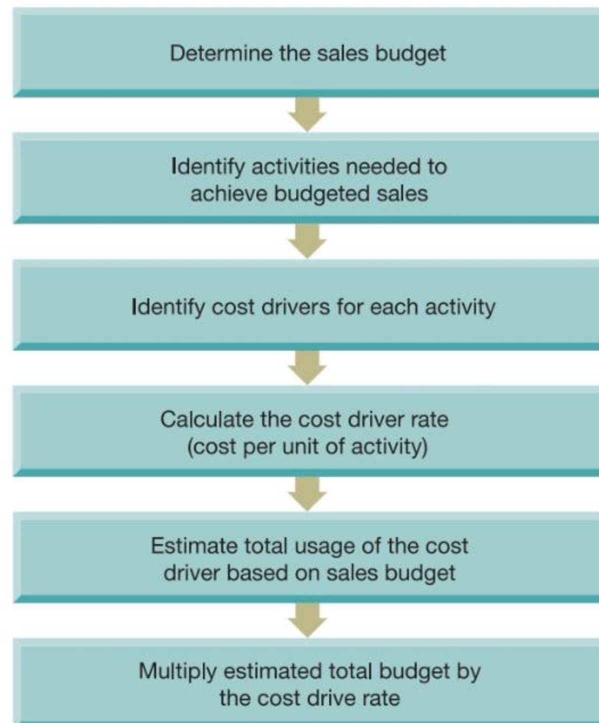

Figure 8.4 Main steps in the ABB process
Source: ATRILL, P. and E.J. McLANEY. Management accounting for decision makers

Under ABB, budgets are prepared based on the various activities carried out. They are not prepared according to function, as occurs with under the conventional approach. Each activity has a cost pool and there is a separate budget for each cost pool. Through the application of ABC principles, the factors that cause costs are known and there is a direct linking of costs with output.

This means that ABB should provide a better understanding of future resource needs and more accurate budgets. It should also provide a better understanding of the effect on budgeted costs of changes in the usage of the cost driver because of the explicit relationship between cost drivers, activities and costs.

Control should be improved within an ABB environment for two reasons:

- By developing more accurate budgets, managers can be provided with demanding yet realistic targets.
- ABB should ensure that costs are closely linked to responsibilities. Managers who have control over particular cost drivers will become accountable for the costs that are caused. An important principle of effective budgeting is that those responsible for meeting a particular budget (budget holders) should have control over the events that affect performance in their area.

As with ABC, a system of ABB can be **costly to implement and to run**. A careful weighing of costs and benefits should therefore be carried out before considering its adoption. Furthermore, it is only feasible to adopt ABB if the business is also adopting a system of ABC. ABB and traditional absorption costing will not blend together.

8.7 Beyond Budgeting Models

The new "**beyond budgeting**" model promotes a more decentralized, participative approach to managing the business. It is claimed that the traditional hierarchical management structure, where decision making is concentrated at the higher levels of the hierarchy, encourages a culture of dependency where meeting the budget targets set by senior managers is the key to managerial success. This traditional structure is replaced by a network structure where decision making is devolved to 'front-line' managers. A more open, questioning attitude among employees is encouraged by the new structure. There is a sharing of knowledge and best practice; protective behaviour by managers is discouraged. In addition, rewards are linked to targets based on improvement in relative performance rather than to meeting the budget.

It is claimed that this new approach allows greater adaptability to changing conditions, increases performance and increases motivation among staff. Figure 8.5 sets out the main differences between the traditional and 'beyond budgeting' planning models.

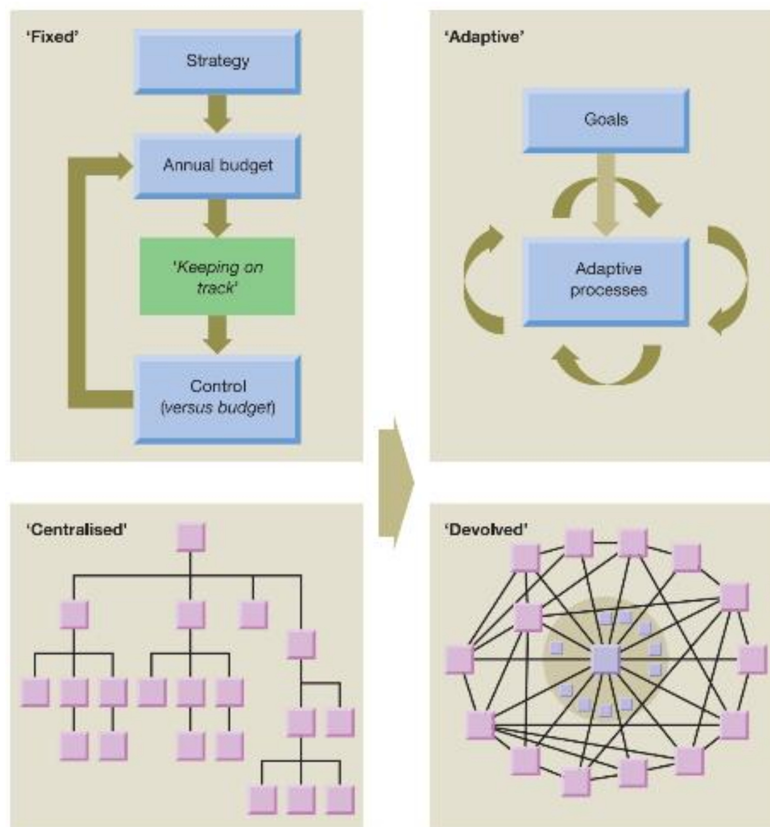

Figure 8.5 Beyond budgeting
Source: ATRILL, P. and E.J. McLANEY. Management accounting for decision makers

The new systems that have been implemented are often based around a leaner financial planning process that is more closely linked to other measurement and reward systems. Emphasis is placed on the use of rolling forecasts and key performance indicators (such as market share, customer satisfaction and innovations) that identify both monetary and non-monetary targets to be achieved both over the long term and in the short term.

Kaizen budgeting (*Kaizen in Japanese means continuous improvement*) explicitly incorporates continuous improvement anticipated during the budget period into the budget numbers. Many companies that have cost reduction as a strategic focus, including General Electric in the United States and Citizens Watch and Toyota in Japan, use kaizen budgeting to continuously reduce costs. Much of the cost reduction associated with kaizen budgeting arises from many small improvements rather than "quantum leaps." Many of these improvements come from employee suggestions as a result of managers creating a culture that values, recognizes, and rewards employee suggestions. Employees who actually do the job, whether in manufacturing, sales, or distribution, have the best information and knowledge of how the job can be done better.

Managers can also apply Kaizen budgeting to activities such as setups with the goal of reducing setup time and setup costs, or distribution with the goal of reducing the cost of moving each cubic foot of table. Kaizen budgeting for specific activities are key building blocks of the master budget for companies that use the Kaizen approach.

8.8 Budgeting and Responsibility Accounting

To attain the goals described in the master budget, top management must coordinate the efforts of all its employees - from senior executives through middle levels of management to every supervised worker. To coordinate the company's efforts, top management assigns responsibility to managers and holds them accountable for their actions. How each company structures its own organization significantly shapes how the company coordinates its actions.

Organization structure is an arrangement of lines of responsibility within an organization. Some companies are organized by business function (exploration, refining, marketing, and so on), other companies are organized primarily by product line or brand. Each manager, regardless of level, is in charge of a **responsibility center**. A responsibility center is a part, segment, or subunit of an organization whose manager is accountable for a specified set of activities. Higher-level managers have broader responsibility centers and a larger number of subordinates.

Responsibility accounting is a system that measures the plans, budgets, actions, and actual results of each responsibility center. There are four types of responsibility centers:

1. **Cost center** – the manager is accountable for costs only.
2. **Revenue center** – the manager is accountable for revenues only.
3. **Profit center** – the manager is accountable for revenues and costs.
4. **Investment center** – the manager is accountable for investments, revenues, and costs.

A responsibility center can be structured to promote better alignment of individual and company goals.

Budgets coupled with responsibility accounting provide feedback to top management about the performance relative to the budget of different responsibility center managers. Differences between actual results and budgeted amounts are called **variances**. These differences are useful in at least three ways:

1. **Early warning.** Variances alert managers early to events not easily or immediately evident. Managers can then take corrective actions or exploit the available opportunities.
2. **Performance evaluation.** Variances prompt managers to probe how well the company has performed in implementing its strategies.
3. **Evaluating strategy.** Variances sometimes signal to managers that their strategies are ineffective.

Controllability is the degree of influence that a specific manager has over costs, revenues, or related items for which he or she is responsible.

A controllable cost is any cost that is primarily subject to the influence of a given responsibility center manager for a given period.

Summary

A budget is a short-term business plan, expressed in financial or in physical terms. Budgets are the short-term means of working towards the business's objectives. They are usually prepared for a one-year period with sub-periods of a month. There is usually a separate budget for each key area.

Periodic budgets are prepared for a particular period (usually one year). **Continual (rolling) budgets** are continually updated, thereby ensuring, that there are budgets for a full planning period.

Uses of budgets are: they promote forward thinking, help coordinate the various aspects of the business, motivate performance, provide the basis of a system of control, provide a system of authorisation.

The budget-setting process is as follows:

- Establish who will take responsibility.
- Communicate guidelines.
- Identify key factor.
- Prepare budget for key factor area.
- Prepare draft budgets for all other areas.
- Review and coordinate.
- Prepare master budgets (income statement and statement of financial position).
- Communicate the budgets to interested parties.
- Monitor performance relative to budget.

Incremental budgets are often based on those of previous periods, with some adjustment for factors affecting the forthcoming period. **Zero-based budgeting** (ZBB) rests on the philosophy that all spending must be justified. ZBB promotes a more questioning approach in order to achieve a more efficient use of resources.

Activity-based budgeting (ABB) extends the principles of ABC to budgeting. Budgets are based on the cost-driving activity rather than a business function. It can result in more accurate budgets and closer links between costs and management responsibilities.

To major **criticisms of budgets belong**:

- Cannot deal with rapid change.
- Focus on short-term financial targets, rather than value creation.
- Encourage a 'top-down' management style.
- Can be time-consuming.
- Based around traditional business functions and do not cross boundaries.
- Encourage incremental thinking (last year's figure, plus x per cent).
- Protect rather than lower costs.
- Promote 'sharp' practice among managers.
- Budgeting is still widely regarded as useful and extensively practiced despite the criticisms and the costliness of a traditional budgeting system.
- Even businesses that claim to have abandoned budgets use planning and control devices that appear to be budgets by another name.

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