MANAGEMENT ACCOUNTING: BUDGETING

STUDY TEXT

Qualifications and Credit Framework

AQ2016

The Study Text supports study for the following AAT qualifications:

AAT Professional Diploma in Accounting – Level 4

AAT Level 4 Diploma in Business Skills

AAT Professional Diploma in Accounting at SCQF – Level 8

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STUDY TEXT

INTRODUCTION

HOW TO USE THESE MATERIALS

These Kaplan Publishing learning materials have been carefully designed to make your learning experience as easy as possible and to give you the best chance of success in your AAT assessments.

They contain a number of features to help you in the study process.

The sections on the Unit Guide, the Assessment and Study Skills should be read before you commence your studies.

They are designed to familiarise you with the nature and content of the assessment and to give you tips on how best to approach your studies.

STUDY TEXT

This study text has been specially prepared for the revised AAT qualification introduced in September 2016.

It is written in a practical and interactive style:

- key terms and concepts are clearly defined
- all topics are illustrated with practical examples with clearly worked solutions based on sample tasks provided by the AAT in the new examining style
- frequent activities throughout the chapters ensure that what you have learnt is regularly reinforced
- ‘pitfalls’ and ‘examination tips’ help you avoid commonly made mistakes and help you focus on what is required to perform well in your examination
- ‘Test your understanding’ activities are included within each chapter to apply your learning and develop your understanding.

ICONS

The study chapters include the following icons throughout.

They are designed to assist you in your studies by identifying key definitions and the points at which you can test yourself on the knowledge gained.

Definition

These sections explain important areas of knowledge which must be understood and reproduced in an assessment .

Example

The illustrative examples can be used to help develop an understanding of topics before attempting the activity exercises.

Test your understanding

These are exercises which give the opportunity to assess your understanding of all the assessment areas.

Quality and accuracy are of the utmost importance to us so if you spot an error in any of our products, please send an email to mykaplanreporting@kaplan.com with full details.

Our Quality Co-ordinator will work with our technical team to verify the error and take action to ensure it is corrected in future editions.

Progression

There are two elements of progression that we can measure: first how quickly students move through individual topics within a subject; and second how quickly they move from one course to the next. We know that there is an optimum for both, but it can vary from subject to subject and from student to student. However, using data and our experience of student performance over many years, we can make some generalisations.

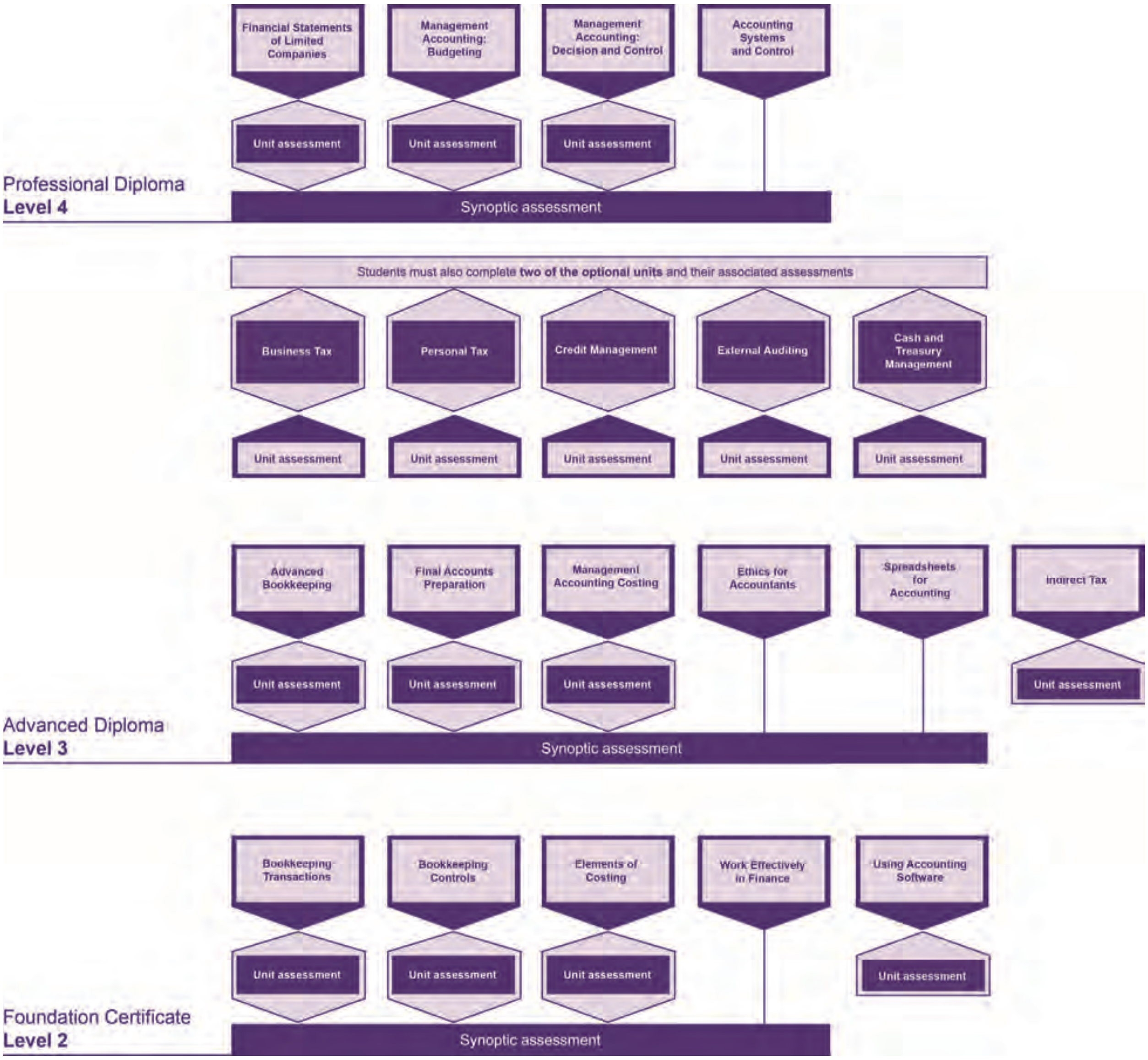
A fixed period of study set out at the start of a course with key milestones is important. This can be within a subject, for example 'I will finish this topic by 30 June', or for overall achievement, such as 'I want to be qualified by the end of next year'.

Your qualification is cumulative, as earlier papers provide a foundation for your subsequent studies, so do not allow there to be too big a gap between one subject and another.

We know that exams encourage techniques that lead to some degree of short term retention, the result being that you will simply forget much of what you have already learned unless it is refreshed (look up Ebbinghaus Forgetting Curve for more details on this). This makes it more difficult as you move from one subject to another: not only will you have to learn the new subject, you will also have to relearn all the underpinning knowledge as well. This is very inefficient and slows down your overall progression which makes it more likely you may not succeed at all.

In addition, delaying your studies slows your path to qualification which can have negative impacts on your career, postponing the opportunity to apply for higher level positions and therefore higher pay.

You can use the following diagram showing the whole structure of your qualification to help you keep track of your progress.


Financial Statements of Limited Companies
Management Accounting: Budgeting
Management Accounting: Decision and Control
Accounting Systems and Control
Unit assessment
Unit assessment
Unit assessment
Professional Diploma
Level 4
Synoptic assessment
Students must also complete two of the optional units and their associated assessments
Business Tax
Personal Tax
Credit Management
External Auditing
Cash and Treasury Management
Unit assessment
Unit assessment
Unit assessment
Unit assessment
Unit assessment
Advanced Bookkeeping
Final Accounts Preparation
Management Accounting Costing
Ethics for Accountants
Spreadsheets for Accounting
Indirect Tax
Unit assessment
Unit assessment
Unit assessment
Unit assessment
Advanced Diploma
Level 3
Synoptic assessment
Bookkeeping Transactions
Bookkeeping Controls
Elements of Costing
Work Effectively in Finance
Using Accounting Software
Unit assessment
Unit assessment
Unit assessment
Unit assessment
Foundation Certificate
Level 2
Synoptic assessment

UNIT GUIDE

Introduction

This unit is about the use of budgeting for planning, coordinating and authorising the activities of an organisation, and for controlling costs. The unit provides skills and knowledge to improve the performance of an organisation by setting targets, constructing achievable plans and monitoring results.

Students will develop a range of skills within the context of planning and control. These include management accounting, statistical analysis, written communication and variance analysis. The application of standard costing, and its links to budgeting, is also included, although the topic is covered in detail in the Management Accounting: Decision and Control unit.

Students will also develop their business awareness. In particular, they will gain elementary understanding of production planning (efficiency, adjusting for changing inventory levels, material control, staff planning, plant scheduling) and aspects of marketing (competition, promotion, product life cycle and so on). In this context, performance measures are used to set targets and monitor performance. These are not high-level financial indicators, such as return on net assets as learned in other units, but detailed measures relevant to specific budgets. As an example, average hourly labour rate would be relevant to the control of a direct labour cost budget.

Budgeting could be described as the art of the possible. Budgets are constructed from forecasts and plans. Forecasts relate to external factors, over which management may have very little influence. Plans relate to the organisation's activities and must be managed.

Management Accounting: Budgeting is a **mandatory** unit. Its content links with Management Accounting: Decision and Control but the application here is specifically to budgeting.

Learning outcomes

On completion of this unit the learner will be able to:

- prepare forecasts of income and expenditure
- prepare budgets
- demonstrate how budgeting can improve organisational performance
- report budgetary information to management in a clear and appropriate format.

Scope of content

To perform this unit you will need to know and understand the following:

		Chapter
1	**Prepare forecasts of income and expenditure**	
1.1	**Identify internal and external sources of information used to forecast income and expenditure** Students need to be able to: • select the appropriate sources of data to use for forecasting • describe their sources of data when issuing forecast. Budget data is drawn from a wide variety of sources within the organisation and externally. Students must be able to suggest an appropriate, reliable source for each piece of information required in budget construction. They will not be expected to have a detailed knowledge of, for instance, government statistical publications, but must be able to demonstrate that they know which external source, or which member of the organisation, to go to for data required for forecasting.	2

Delivering this unit

This unit has the following links across the AAT Professional Diploma in Accounting.

Unit name	Content links	Suggested order of delivery
Management Accounting: Decision and Control Cash and Treasury Management	This unit and Management Accounting: Decision and Control are complementary, forming the management accounting element of the level 4 qualification. Some criteria appear in both units, such as statistical techniques, performance measures and writing management reports. The application of these is broader in Management Accounting: Decision and Control than in Management Accounting: Budgeting. There is also a small overlap with the optional unit Cash and Treasury Management. However, preparation of a cash flow forecast from budget data only appears in Management Accounting: Budgeting.	Students may find it useful to study Management Accounting: Decision and Control and Management Accounting: Budgeting concurrently, as there are many overlapping concepts.

THE ASSESSMENT

Test specification for this unit assessment

Assessment type	Marking type	Duration of exam
Computer based assessment	Partially computer/ partially human marked	2.5 hours

The assessment for this unit consists of 8 compulsory, independent, tasks.

The competency level for AAT assessment is 70%.

Learning outcomes		Weighting
1	Prepare forecasts of income and expenditure	10%
2	Prepare budgets	35%
3	Demonstrate how budgeting can improve organisational performance	35%
4	Report budgetary information to management in a clear and appropriate format	20%
Total		100%

UNIT LINK TO SYNOPTIC ASSESSMENT

AAT AQ16 introduced a Synoptic Assessment, which students must complete if they are to achieve the appropriate qualification upon completion of a qualification. In the case of the Professional Diploma in Accounting, students must pass all of the mandatory assessments and the Synoptic Assessment to achieve the qualification.

As a Synoptic Assessment is attempted following completion of individual units, it draws upon knowledge and understanding from those units. It may be appropriate for students to retain their study materials for individual units until they have successfully completed the Synoptic Assessment for that qualification.

With specific reference to this unit, the following learning objectives are also relevant to the Professional Diploma in Accounting Synoptic Assessment

LO3 Demonstrate how budgeting can improve organisational performance

STUDY SKILLS

Preparing to study

Devise a study plan

Determine which times of the week you will study.

Split these times into sessions of at least one hour for study of new material. Any shorter periods could be used for revision or practice.

Put the times you plan to study onto a study plan for the weeks from now until the assessment and set yourself targets for each period of study – in your sessions make sure you cover the whole course, activities and the associated questions in the workbook at the back of the manual.

If you are studying more than one unit at a time, try to vary your subjects as this can help to keep you interested and to see the relationships between subjects.

When working through your course, compare your progress with your plan and, if necessary, re-plan your work (perhaps including extra sessions) or, if you are ahead, do some extra revision/practice questions.

Effective studying

Active reading

You are not expected to learn the text by rote, rather, you must understand what you are reading and be able to use it to pass the assessment and develop good practice.

A good technique is to use SQ3Rs – Survey, Question, Read, Recall, Review.

1 **Survey the chapter**

Look at the headings and read the introduction, knowledge, skills and content, so as to get an overview of what the chapter deals with.

2 **Question**

Whilst undertaking the survey ask yourself the questions you hope the chapter will answer for you.

3 Read

Read through the chapter thoroughly working through the activities and, at the end, making sure that you can meet the learning objectives highlighted on the first page.

4 Recall

At the end of each section and at the end of the chapter, try to recall the main ideas of the section/chapter without referring to the text. This is best done after short break of a couple of minutes after the reading stage.

5 Review

Check that your recall notes are correct.

You may also find it helpful to reread the chapter to try and see the topic(s) it deals with as a whole.

Note taking

Taking notes is a useful way of learning, but do not simply copy out the text. The notes must

- be in your own words
- be concise
- cover the key points
- well organised
- be modified as you study further chapters in this text or in related ones.

Trying to summarise a chapter without referring to the text can be a useful way of determining which areas you know and which you don't.

Three ways of taking notes

1 Summarise the key points of a chapter

2 Make linear notes

A list of headings, subdivided with sub-headings listing the key points.

If you use linear notes, you can use different colours to highlight key points and keep topic areas together.

Use plenty of space to make your notes easy to use.

3 Try a diagrammatic form

The most common of which is a mind map.

To make a mind map, put the main heading in the centre of the paper and put a circle around it.

Draw lines radiating from this to the main sub-headings which again have circles around them.

Continue the process from the sub-headings to sub-sub-headings.

Annotating the text

You may find it useful to underline or highlight key points in your study text – but do be selective.

You may also wish to make notes in the margins.

Revision phase

Kaplan has produced material specifically designed for your final examination preparation for this unit.

These include pocket revision notes and a bank of revision questions specifically in the style of the new syllabus.

Further guidance on how to approach the final stage of your studies is given in these materials.

Further reading

In addition to this text, you should also read the 'Student section' of the 'Accounting Technician' magazine every month to keep abreast of any guidance from the examiners.

TERMINOLOGY

There are different terms used to mean the same thing – you will need to be aware of both sets of terminology.

UK GAAP	IAS
Profit and loss	Income statement
Sales	Revenue
Balance sheet	Statement of financial position
Fixed assets	Non-current assets
Stock	Inventory
Trade debtors	Trade receivables
Trade creditors	Trade payables
Capital	Equity
Profit	Retained earnings

Responsibility centres and the behavioural aspects of budgeting

1

Introduction

This chapter provides general background information to the context of budgeting as a key element of management accounting. It is essential background knowledge and should be useful in answering tasks in the exam.

ASSESSMENT CRITERIA

- Identify budgetary responsibilities and accountabilities (Element 2.1)
- Discuss how budgeting can promote effective, ethical and focused management (Element 3.1)
- Discuss the use of budgeting for planning, coordinating, authorising, and cost control (Element 3.2)

CONTENTS

1 Planning, budgeting and forecasting

1.1 Introduction

Given the increasing complexity of business and the ever-changing environment faced by firms it is doubtful whether any firm can survive by simply continuing to do what it has always done in the past. If the firm wishes to earn satisfactory levels of profit in the future, it must plan its course of action in order to attempt to improve its performance.

In a management accounting context, the budgeting process is part of the overall planning process.

1.2 The concept of corporate planning

Planning is an important concept in all walks of life, including your preparation for examinations. A **plan** is a series of actions to be carried out if objectives and goals are to be met.

In a business context, the term corporate planning is often used. **Corporate planning** is a long run, on-going activity which seeks to determine the direction in which the firm should be moving in the future:

'Where do we see ourselves in ten years time?'

Frequently asked questions in formulating the corporate plan are:

(a) the reason why the company exists (its **mission**)

(b) what it wants to achieve (its corporate **objectives**)

(c) how it intends to get there (its business **strategy**)

(d) what resources will be required (its **operating plans**)

(e) how well it does in comparison to the plan (**control**).

These areas are discussed below.

Mission is a broad statement of the overall aims of the organisation.

A clearly defined mission, which is widely publicised within and outside the organisation, will guide it in its decision making. Most organisations now prepare and publish their mission in a document known as a mission statement.

Examples of real world mission statements are:

- ‘To be the industry leader in the vehicle interior trims market by offering excellent quality, flexibility and value, by proactively partnering our customers in a joint mission to create a world class service.’

- Our mission: 'To make Hampshire safer' (Hampshire Fire Brigade).
- ‘Our Corporate Mission Statement is for Fly Magic to become the largest pleasure flying organisation in the UK.’

Note that mission statements give an overall aim or goal which is not time specific and not quantified. You should contrast this with the concept of objectives dealt with below.

Corporate objectives are quantified, time-limited statements of what a firm wishes to achieve. Traditionally it was assumed that all firms were only interested in the maximisation of profit (or the wealth of their shareholders). Nowadays it is recognised that for many firms profit is only one of many objectives pursued.

Examples of other objectives include:

(a) maximisation of sales (whilst earning a 'reasonable' level of profit)

(b) growth (in sales, asset value, number of employees, etc.)

(c) survival

(d) research and development leadership

(e) quality of service

(f) contented workforce

(g) respect for the environment.

For corporate planning purposes it is essential that the objectives chosen are quantified and have a timescale attached to them. It has been suggested that objectives should be SMART:

- **S**pecific
- **M**easurable
- **A**chievable
- **R**elevant
- **T**ime limited

A statement such as maximise profits and increase sales would be of little use in corporate planning terms. The following would be far more helpful:

(a) achieve a growth in profit of 5% per annum over the coming ten-year period

(b) obtain a revenue of $x million within six years

(c) launch at least two new products per year, etc.

Some objectives may be difficult to quantify (e.g. contented workforce) but if no attempt is made there will be no yardstick against which to compare actual performance.

Strategy is the course of action, including the specification of resources required, that the company will adopt to achieve its specific objective.

Strategy formulation usually involves:

(a) an analysis of the environment in which the firm operates, a review of the strengths and weaknesses of the company and a consideration of the threats and opportunities facing it

(b) the results of the firm's existing operations are then projected forward and compared with stated objectives

(c) any differences between projected performance and objectives ('gaps') are identified.

To bridge these gaps the firm will either change its objectives (because they are too optimistic) or attempt to change the firm's direction to improve performance. This change of direction is strategy formulation.

Formulation of strategy is largely a creative process, whereby the firm will consider the products it makes and the markets it serves. Typical strategies include:

- market penetration (sell more of existing products to existing customers)
- product development (new products sold to existing customers)
- market development (continue in existing markets, develop new ones)
- diversification (develop new products and sell them to new customers).

These strategies might be followed either:

- internally – for example, the company develops its own products
- by acquisition – the company buys another which currently has the product range it wants.

Operating plans are the short-term tactics of the organisation.

A strategic plan might call for expansion in a particular market; whereas the operating plan will detail how the extra products are to be made and how much is to be spent on advertising. Military analogy is useful here – strategy is how to organise to win the war, operating plans (or tactics) are how to fight individual battles.

Control is the comparison of the results of the plans and the stated objectives to assess the firm's performance, and the taking of action to remedy any differences in performance.

This is an essential activity as it highlights any weakness in the firm's corporate plan or its execution. Plans must be continually reviewed because as the environment changes so plans and objectives will need revision. Corporate planning is not a once-in-every-ten-years activity, but an 'on-going' process which must react quickly to the changing circumstances of the firm.

Overview of the planning process

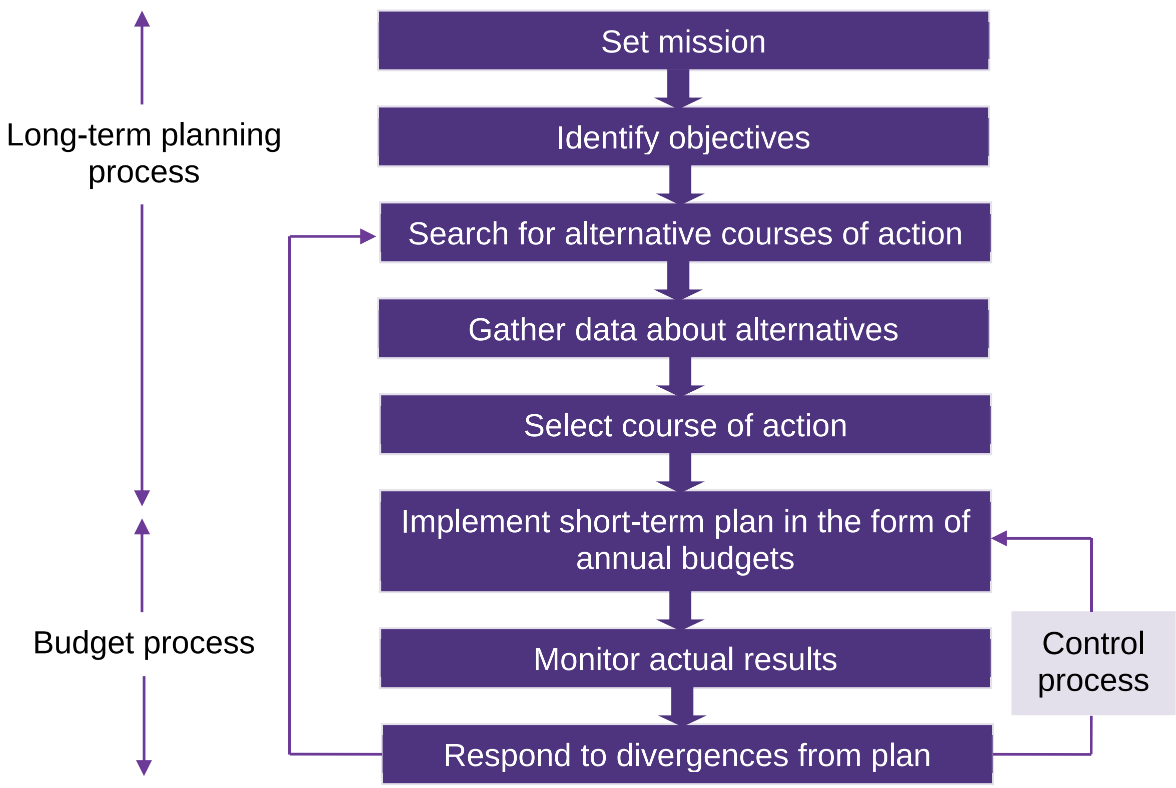
The overall planning and control process is summarised in the diagram that follows.

You will note that the bottom section of the diagram introduces the word budget.

We saw earlier the concept of a plan and mentioned the example of students having a plan to help them to achieve their objective of passing examinations. You, as an individual, might take the view that you can afford to buy this (essential and invaluable) textbook, but you may not be able to afford to attend a series of expensive seminars held in upmarket hotels where leading experts discuss management accounting topics in great detail. By taking this view, you are, in effect turning your plan to pass the examination into a budget.

The classic concept of a budget is that it takes a plan, which might be in terms of, say hours, number of units of sales etc. and turns it into MONEY terms.

A budget is a plan in monetary terms.



The eight stages are explained below:

(a) **Set mission**

This involves establishing the broad overall aims and goals of the organisation – these may be both economic and social.

(b) **Identify objectives**

This requires the company to specify objectives towards which it is working. These objectives may be in terms of:

- economic targets
- type of business
- goods/services to be sold
- markets to be served
- market share
- profit objectives
- required growth rates of sales, profits, assets.

(c) **Search for possible courses of action**

A series of specific strategies should be developed dealing particularly with:

- developing new markets for existing products
- developing new products for existing markets
- developing new products for new markets.

(d) **Gather data about alternatives and measuring pay-offs**

This is an information-gathering stage.

(e) **Select course of action**

Having made decisions, long-term plans based on those decisions are created.

(f) **Implement of short-term plans**

This stage signals the move from long-term planning to short-term plans in the form of annual budgeting. The budget provides the link between the strategic plans and their implementation in management decisions. The budget should be seen as an integral part of the long-term planning process.

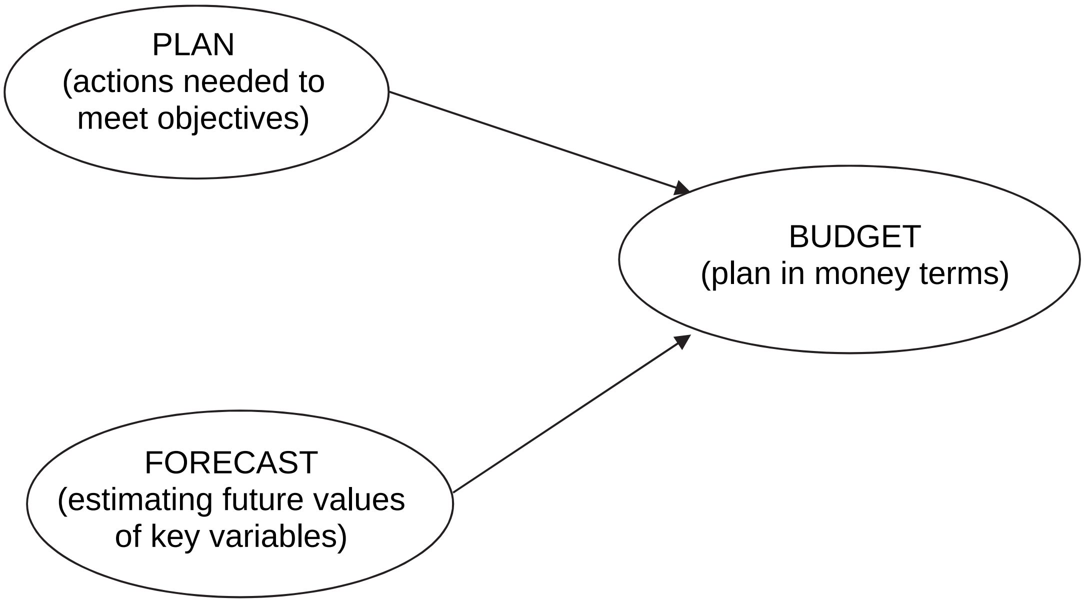
(g) **Monitor actual outcomes**

This is the particular role of the cost accountant, keeping detailed financial and other records of actual performance compared with budget targets (variance accounting).

(h) **Respond to divergences from plan**

This is the control process in budgeting, responding to divergences from plan either through budget modifications or through identifying new courses of action.

Before we leave this section we should relate together some of the most important features of management accounting, and of your examination syllabus, which we have now seen:



This indicates that the preparation of a budget, the subject matter of this and the next few chapters in this book needs a plan to be in place AND requires relevant forecast information to be available. Planning and forecasting are seen to be essential preliminary steps in the budgetary process.

1.3 Influences on planning and control systems

The planning and control system in all organisations should follow the general structure set out above. However, the detail of the process will be influenced by a number of factors and therefore will vary from one organisation to another.

The principal factors which will influence the process in a given organisation will include:

- organisational structure
- corporate objectives
- administrative procedures
- the nature of the activities of the business.

2 Responsibility accounting

Examinations frequently require a discussion on whether the budgeting procedures used within an organisation are likely to achieve their aims.

These aims, and the methods used to achieve them, can be broadly categorised as follows:

- efficient management – management by exception
- motivation of workforce – responsibility accounting.

2.1 Management by exception

The features of this method of reporting are that:

(a) attention is drawn only to areas where operations are seen to be 'out of control'

(b) this may be achieved by identifying those variances that are deemed to be 'exceptional'

(c) only these variances will be investigated and (where possible) corrected

(d) management time and expertise are utilised where it can be most effective in improving the efficiency of future operations.

For it to be effective, it is important that:

- exceptional variances are correctly isolated
- only such variances owing to factors capable of correction be considered for investigation
- costs and benefits of investigation are assessed.

2.2 Responsibility accounting

The aim of a responsibility accounting system is to motivate management at all levels to work towards the company's objectives with the minimum of direction.

What is involved?

(a) The use of budgets as 'targets' against which management performance may be measured and (often) rewarded.

(b) The presentation of 'performance reports' relating to particular responsibility centres. These centres fall into four categories as follows.

  (i) **Cost centre** or **expense centre** where a manager is held responsible for control of expenditure.

(ii) A **revenue centre** is a part of the organisation that earns sales revenue. It is similar to a cost centre, but only accountable for revenues, and not costs.

(iii) **Profit centre** where a manager is held responsible for control of sales revenue and expenditure.

(iv) **Investment centre** where a manager is held responsible for investment decisions as well as the control of sales revenue and expenditure.

(c) The requirement that the person deemed responsible for that area should give explanations of significant variances shown therein.

Examinations on this subject tend to concentrate on a practical application of the principles necessary for a system of responsibility accounting to work effectively, and often require the preparation of a draft performance report, or the criticism of such a report. An in-depth theoretical knowledge of the work carried out in this field is not needed; a common sense approach to a practical problem suffices.

2.3 Budgets and motivation

Motivation is the drive or urge to achieve an end result. Motivation can be as a force operating within an individual which drives that individual on to attain some goals or objectives. The word motivation comes from the Latin word meaning to move – this shows the key idea involved. An individual is motivated if they are moving forward to achieving goals or objectives.

Motivation may affect many aspects of the life of an individual. You have to be motivated to pass your examinations and to gain a recognised accounting qualification. At work you are motivated to achieve promotion and to gain a position of greater authority and responsibility within the organisation.

In a business context, if employees and managers are not motivated, they will lack the drive or urge to improve their performance and to help the organisation to achieve its goals and move forward. This is the importance of motivation in a business.

Three main areas need to be examined in relation to the use of budgets in responsibility accounting:

(a) participation in budget setting

(b) budgets as motivational targets

(c) performance evaluation and reward.

The conclusions under each of these headings are largely common sense – you should try to think up practical examples in relation to your own position in study or at work to help you remember them.

3 Participation in budget setting

Conventional wisdom suggests that managers should be encouraged to participate in the budget setting process and that the budget should be built up from the lower rungs of management ('bottom up' budgeting) rather than imposed from above ('top down' budgeting).These are the advantages:

- Managers will then feel that they 'own' the budget and will therefore be more committed to the targets and motivated to achieve them.
- Operating managers are often the only people with sufficient detailed knowledge to develop a meaningful budget.

3.1 Disadvantages of participation

However, there are disadvantages to participation.

- The objectives of the managers and the objectives of the organisation may not be the same. 'Goal congruence' does not automatically result from empowering managers to develop their own budgets.
- Operating management may use their knowledge to manipulate the budget. They may deliberately set targets that they cannot fail to achieve, particularly if bonuses are awarded for meeting the budget.
- Managers may not wish to participate in the budget setting process. This may be because:
  - (i) they simply want to know what their targets are
  - (ii) they do not have the technical expertise to participate in budget setting
  - (iii) they do not have the necessary commitment to the organisation
  - (iv) they feel that the budget will be 'used against them'.

3.2 Budgets as motivational targets

In general, it is accepted that corporate objectives are more likely to be met if they are expressed as quantified targets, often in the form of budgets.

If a target is to have any influence on performance:

- the recipient must be aware of its existence and feel committed to achieving it
- it must be set at the right level of difficulty to act as a motivator; both unrealistic and over-generous targets will be demotivational.

In theory, there may be a need for two budgets to be prepared for the same area.

- One should be a challenging (aspirations) budget to motivate the manager.
- The second should be a lower, and more realistic, expectations budget for planning and decision purposes.

Care should be taken to reward success as well as penalising failure, in order that a benefit is perceived in bettering rather than just achieving the target.

Budgets become stronger motivators as they become tighter up to a point, but thereafter motivation declines. The optimal degree of tightness depends on both the situation and the personality of the individuals concerned.

Empirical evidence suggests that if a budget target is set that is too easy, then actual performance will be a little better than the budget but it will not be optimised. In other words, managers do not usually work to their full potential if they know that a lower level of performance will still meet the budget – human behaviour will tend to lead to individuals putting in the minimum possible effort to achieve a set target. If greater effort were applied, a higher target may be achieved.

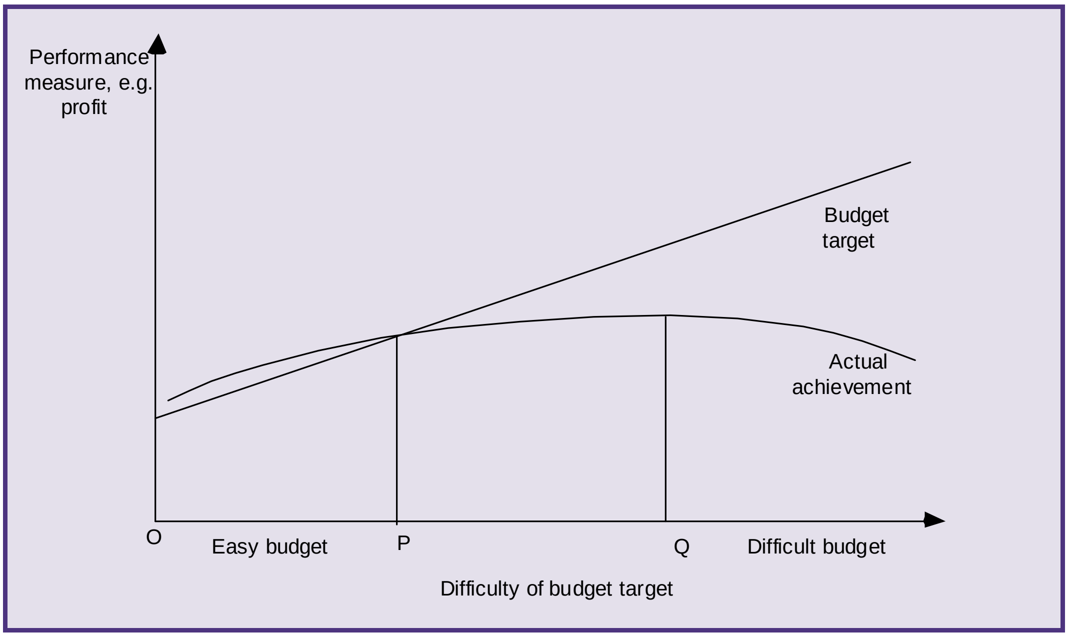
On the other hand, if the budget is too difficult, because it is based on ideal levels of performance, managers become discouraged at what they regard as an unattainable standard. This may de-motivate and as a result, actual performance falls short of what might reasonably have been expected.

You can apply these points to your own position in the context of examinations. If the pass mark for an examination is very low – say 10% – you know you can pass with little effort and you will (perhaps) not work to your full potential. On the other hand, if the pass mark were 99% you would, probably, view that as impossible to achieve and decide not to try at all!

The aim should be to agree a budget that falls between these two extremes and therefore incorporates just the right degree of difficulty which will lead to the optimal level of performance. At this level the budget should be challenging enough to motivate a manager to optimise his performance without being too ambitious. Authors writing on this subject have used the phrase ‘tough but attainable’ for the targets to be set.

The right level of difficulty is that which is acceptable to that individual manager. This level of acceptability will differ from manager to manager, as each individual behaves and reacts in a different way in similar circumstances.

This concept of budget difficulty can be demonstrated diagrammatically as follows:



- A budget set at the degree of difficulty represented by point P is referred to as an 'expectations budget' as budget target and actual achievement are likely to coincide. The target level of performance has been met.
- However, a relatively easy-to-achieve budget, (set to the left of point P), is likely to lead to sub-optimal actual performance in that, although the budget has been met, the ACTUAL performance is at a relatively low level.
- In order to achieve a higher actual performance a more difficult budget needs to be set (an 'aspirations budget') at some point between P and Q. A budget set where point Q represents the degree of difficulty should lead to optimal performance (highest point on the 'actual' performance curve). However, it should be noted that this would give rise to an adverse variance compared with budget. If this target is set, senior management should not penalise the manager for the adverse variance, which may be unavoidable.

The diagram brings out one of the most fundamental points in budgeting:

How the degree of difficulty, represented by point Q, is determined is not at all easy in practice because it involves a knowledge of how each individual manager will react and behave. Attempts to quantify the degree of difficulty using work study assessments are a highly simplified approach to a very complex problem.

Furthermore, attempts to use the budget as a motivating tool in the manner described may in fact lead to the need for two budgets.

- One is the total of what all the individual managers have agreed to achieve (with the different degrees of budget difficulty incorporated into them).
- The second may recognise that actual performance is likely to fall short of aspiration and is, therefore, a more realistic basis for planning purposes.

Test your understanding 1

World History Museum

The World History Museum has an Education Department which specialises in running courses in various subjects.

You have recently started work as the assistant management accountant for the museum. During a discussion with Chris Brooks, the general manager, she expresses to you that her interest in the control aspects of budgeting has been sparked by her attendance on a course entitled 'Budgetary control for managers'. She has shown you the following extract from the course notes she was given:

> *'A system of participative budgeting involves managers in the process of setting their own budgets. Participative systems are likely to be more successful in planning and controlling the activities of an organisation.'*

Write a brief memo to Chris Brooks which explains the advantages and disadvantages of participative budgeting as a part of the budgetary planning and control process.

3.3 Performance evaluation and reward

Managers should only be held accountable for items over which they have control, and measures of performance should be devised that promote decisions in line with corporate objectives.

Thus a manager of a profit centre may be judged by variances affecting sales and direct costs (before allocated fixed costs); the performance of the centre itself will be measured by direct controllable contribution (having accounted for costs that are directly attributable to that centre, but not necessarily all controlled by the manager).

There are three main styles of management in the use of budget performance reports:

(a) The budget-constrained style, which lays particular emphasis on results being closely in accordance with the budget plan.

(b) The profit-conscious style, which is less concerned with current deviations from budget than with a manager's ability to achieve a trend of results which is acceptable in relation to changing conditions.

(c) The non-accounting style, which tends to disregard accounting reports as a means of measuring management performance and instead looks at factors such as:

- the number of customer complaints or substandard items produced
- staff turnover
- morale in the department
- other qualitative measures.

Of the three styles, the middle is probably the most successful in achieving the company's long-term goals. The first creates good cost consciousness but also a great deal of tension between a manager and his subordinates, and manipulation of accounting information. The last promotes general good morale, but managers have a low involvement with costs.

Managers may receive financial rewards (for example, bonuses) and non-financial rewards (for example, promotion or greater responsibility) based on their ability to meet budget targets.

In the previous section the motivating effect of budgets was considered, but it should be remembered that the budgets by themselves have a limited motivational effect. It is the reward structure that is linked to achieving the budget requirements, or lack of reward for non-achievement, which provides the real underlying motivational potential of budgets.

A manager will need to regard the reward as being worthwhile if his behaviour is to be influenced so that he/she strives actively towards the achievement of the budget.

It is a common practice to attempt to assess the performance of a manager by a comparison of budgeted and actual results for his area of responsibility in the organisation. The choice of which particular measures to use is important to ensure that the individual manager sees the attainment of his targets as worthwhile for himself and at the same time in the best interests of the organisation as a whole – this is the concept of goal congruence which we saw in the chapter on responsibility accounting and which we shall cover again later in this chapter. In practice, conflicts can and often do arise between individual managers' personal objectives and those of the organisation as a whole.

The way in which the information in budget reports is used in the assessment of managerial performance has to be considered. Different degrees of emphasis on the results of budget versus actual comparisons can lead to different attitudes and feelings among managers. There is a need to achieve the correct balance between on the one extreme, an over-emphasis on results leading to pressure and feelings of injustice from the system; and on the other, too little stress on results leading to a budget irrelevancy attitude and low morale.

In general, we can summarise the characteristics of a sound employee reward system as follows:

- Fairness – the system should reward effort which helps the organisation achieve its objectives.
- Motivational – it should motivate the managers and employees to behave congruently i.e. in a way which assists the organisation to achieve its objectives.
- Understandability – the system should be such that it is clear to managers what they need to do to achieve the rewards. Unduly complex reward systems, perhaps based on complex bonus formulae are unlikely to be effective in generating improved performance.
- Consistently applied – the system should operate in the same way for all employees or, if not possible, for all employees at a given level in the organisation.
- Objective – the system should be based on measurable criteria with a minimum of subjectivity. It should also be such that it is not open to manipulation by managers in their own interests.
- Universal – all employees and managers at all levels in the organisation should be subject to an appraisal and reward system.

'Performance-related pay' is a method of rewarding employees in the form of bonuses, options to buy shares or other incentives, with a view to motivating them to improve their own performance or, in the case of managers, the performance of the part of the organisation which they manage.

Linking remuneration to budget achievement like this has his benefits: it can be a successful method of motivating managers to meet their budgetary targets. However, this only works when there is a short timescale between the target being met and the reward; and the risk is that managers start to focus on meeting short-term goals, rather than looking at the strategic, long-term objectives of the company.

3.4 The top down approach to budgeting

The top down approach is where budgets are set by higher levels of management and then communicated to the lower levels of management to whose areas of responsibility they relate. This is also known as an imposed budget.

In this approach lower-level managers are not allowed to participate in the budget-setting process.

The main problem with this approach is that those responsible for operating the budget will see it as something in which they have had no say. They lack ownership of the budget and as such they will be reluctant to take responsibility for it. It is unlikely to motivate the employees to achieve the budgetary targets set for them.

However, it can be argued that this top down approach may be the only approach to budgeting which is feasible if:

- lower level employees have no interest in participating in the process
- they are not technically capable of participating in budget setting
- only top level management have access to information which is necessary for budgeting purposes – perhaps information which is commercially sensitive.

3.5 The bottom up approach to budgeting

The bottom approach to budgeting is where lower level managers are involved in setting budget targets. This is known as a participative budget.

The more that individual managers are involved in setting budget targets, the more likely it is that they will accept those targets and strive actively towards the attainment of them. Employees are more likely to internalise the budget – accept it as part of themselves.

In this way actual performances should be improved by the motivational impact of budgets.

The main problem is:

- If budgets are used both in a motivational role and for the evaluation of managerial performance, then the problem of budgetary bias may arise.

Budgetary bias is where a manager deliberately sets a lower revenue target or a higher cost target.

By lowering the standard in the budget the target will be easier to achieve and performance will appear to be better. There is evidence to show that this tends to occur where a manager is actively seeking progression within an organisation or where financial rewards are based on ability to beat the budget. The effects of this sort of bias can be minimised by careful control, at the budget setting stage, and over any changes in the budget from one year to the next which are not due to external factors.

- Some people in organisations, by the very nature of their personality, do not wish to participate in the wider aspects of their jobs. They prefer an authoritarian style of leadership and do not strive for independence. Participative approaches to budget-setting will be very limited in their effect in such circumstances.
- Participation will be less effective in organisational situations where a manager or employee feels that he has little scope to influence the actual results for the budgeted area of responsibility. The lower down in the organisation structure the budget holder is, the more constrained is he by factors imposed from above. For example, objectives, strategies and policies, as well as the sales forecast and budget, limit the extent that a subordinate manager in the production function has for real participation in the setting of the budget for his area of responsibility.
- An important point to recognise is the difference between actual and perceived participation. It is the extent to which an individual manager perceives that he has influenced the budget that is crucial in that manager’s acceptance of it.

An extension of this bottom up approach is the concept of budget challenging – employees are given the chance to question a budget presented to them (in a positive way!) before it is finalised.

3.6 Goal congruence

The principle of goal congruence involves ensuring that all members of the organisation pull in the same direction towards helping the organisation to achieve its overall goals and objectives.

If individuals in an organisation fail to demonstrate congruent behaviour, decisions taken may benefit that individual personally or the division which that individual works for, but may not benefit the organisation as a whole – this is known as dysfunctional behaviour.

We saw in the earlier chapter that an appropriate choice of performance evaluation methods is important in this context. The way the budgetary control system is operated can also be significant.

There may be a general fear and misunderstanding about the purpose of budgetary control. It is often regarded as a penny-pinching exercise by top management rather than recognised as a tool of management at all levels in an organisation structure. If this tends to be the attitude, a carefully planned campaign of education and training should be undertaken. Managers should be encouraged to discover how the budgetary control system can be of benefit to them personally as well as how it may benefit the organisation.

Employees may become united against management and devote their energies to finding excuses for not meeting targets. Targets that are realistic, and are seen by the employees as being realistic, are what is required. Good communications involving consultation and participation should help to minimise this problem.

One of the key roles in any organisation is at the supervisor/foreman level where the continual interface between management and employees exists. The leadership and motivational function of a supervisor or foreman is very important if the work is to be done and targets are to be achieved.

Conclusion

The main point to appreciate is that a budgetary control system should have the effect of motivating employees to work in the best interests of the organisation as a whole – the concept of goal congruence.

Participation (the ‘bottom-up’ approach) and education play important roles in encouraging a positive approach to budgeting in the mind of employees.

Test your understanding answers

Test your understanding 1

World History Museum

MEMORANDUM

To: Chris Brooks

From: Assistant Management Accountant

Date: 13 June 20X4

Subject: Participative budgeting

As requested, I enclose brief explanations of the advantages and disadvantages of participative budgeting.

Advantages

(i) Managers are likely to be demotivated if budgets are imposed on them without any prior consultation. If they are consulted, they are more likely to accept the budgets as realistic targets.

(ii) If managers are consulted, then the budgets are more likely to take account of their own aspiration levels. Aspiration levels are personal targets which individuals or departments set for themselves. If budget targets exceed aspiration levels, then the budgets can have a negative motivational impact because they will be perceived as unachievable. However, if the targets fall too far below aspiration levels, then the performance of the individuals or departments may be lower than might otherwise have been achieved.

(iii) Managers who are consulted may be motivated by the feeling that their views are valuable to senior management.

(iv) Managers who are closely involved with the day to day running of operations may be able to give very valuable input to the forecasting and planning process.

Disadvantages

(i) If too many people are involved in budgetary planning, it can make the process very slow and difficult to manage.

(ii) Senior managers may need to overrule decisions made by local managers. This can be demotivating if it is not dealt with correctly.

(iii) The participative process may not be genuine. Managers must feel that their participation is really valued by senior management. A false attempt to appear to be interested in their views can be even more demotivating than a system of imposed budgets.

(iv) Managers may attempt to include excess expenditure in their budgets, due to 'empire-building' or to a desire to guard against unforeseen circumstances.