

## Using budgets

suppliers. A favourable sales revenue variance might be the result of an effective advertising campaign. The business might decide to make more use of the same or similar campaigns in the future. Variance analysis can help business decision-makers because of the information they provide about financial outcomes and their causes.

### Zero-based budgeting

The financial information used in most budgets is based on **historical** data. For example, the cost of materials in this year's production budget may be based on last year's figure, with perhaps an allowance for inflation. Production and manufacturing costs, such as labour, raw materials and overheads, are relatively easy to value and tend to be controlled using methods such as standard costing.

However, in some areas of business it is not so easy to quantify costs. Examples might be certain marketing, administration or computer services costs. Where costs cannot be justified then no money is allocated in the budget for those costs. This is known as **ZERO-BASED BUDGETING (ZBB)** or **ZERO BUDGETING**. A manager must show that a particular item of spending generates an adequate amount of benefit in relation to the general objectives of the business in order for money to be allocated in a budget.

This approach is different to the common practice of extrapolating from past costs. It encourages the regular evaluation of costs and helps to minimise unnecessary purchases. The concept of **opportunity cost** is linked to ZBB. Opportunity cost is the cost of the next best alternative. When choices are made, businesses try to minimise the opportunity cost. ZBB also involves a cautious approach to spending, so that costs are minimised. Both approaches include an element of 'value for money'.

The main advantages of ZBB are that:

- the allocation of resources should be improved;
  - a questioning attitude is developed which will help to reduce unnecessary costs and eliminate inefficient practices;
  - staff motivation might improve because evaluation skills are practised and a greater knowledge of the firm's operations might develop;
  - it encourages managers to look for alternatives.
- ZBB also has some disadvantages.

- It is time consuming because the budgeting process involves the collection and analysis of quite detailed information so that spending decisions can be made.
- Skilful decision making is required. Such skills may not be available in the organisation. In addition, decisions may be influenced by subjective opinions.
- It threatens the status quo. This might adversely affect motivation.
- Managers may not be prepared to justify spending on certain costs. Money, therefore, may not be allocated to spending which could benefit the business.

To deal with these possible problems, a business might give each department a 'base' budget of, say, 50 per cent. Departments could then be invited to bid for increased

expenditure on a ZBB basis.

### Benefits of using budgets

**Monitoring performance** Budgets allow managers to monitor the performance of a business as a whole, as well as different sections. For example, analysing departmental cost variances may allow a business to find out why certain departments are incurring high costs. Alternatively, it allows businesses to identify good practice and discover why some costs are lower.

**Identifying factors affecting performance** Prompt variance analysis allows managers to assess whether variances are caused by internal or external factors. Once causes have been traced, they can be corrected.

**Improved plans in future** By identifying variances and their causes managers may be able to produce more accurate budgets in future. This will aid planning and perhaps improve the performance of the business.

**Improved accountability** Budgetary control in general helps to improve accountability in businesses. It can also be linked to performance-related pay. For example, budget holders may receive a bonus payment at the end of the budget period if they can show favourable variances. Consequently motivation in a business can be improved.

### Drawbacks of using budgets

**Motivation** In some businesses, workers are left out of the planning process. If workers are not consulted about the budget, it will be more difficult to use that budget to motivate them. Budgets which are unrealistic can also fail to motivate staff.

**Manipulation** Budgets can be manipulated by managers. For example, a departmental manager might have great influence over those people co-ordinating and setting budgets. The manager may be able to arrange a budget which is easy to achieve and makes the department look successful. But the budget may not help the business achieve its objectives.

**Rigidity** Budgets can sometimes constrain business activities. For instance, departments within a business may have different views about when it is best to replace vehicles. The more often vehicles are replaced, the higher the cost. However, the newer the vehicle, the lower the maintenance cost and the less likely it is to be off the road for repairs. The budget may be set so that older vehicles have to be kept rather than replaced. But this may lead to customer dissatisfaction and lost orders because deliveries are unreliable.

**Short-termism** Some managers might be too focused on the current budget. They might take actions that undermine the future performance of the business just to meet current budget targets. For example, to keep labour costs down in the current budget period, the manager of a supermarket might reduce staffing on customer service. This might save costs now, but it could lead to customers drifting away over time due to poor service. Consequently the long-term performance of the business would suffer.