3.9 e) The importance of budgets and variances in decision-making (AO2)


A budget is a detailed financial plan for the future, usually involving the expected costs and revenues or a cash flow forecast, for a pre-determined period of time. A budget is produced in order to help a business to achieve its organizational objectives. Budgeting does not guarantee success, but it can certainly help to avoid business failure.

Budgets are important for a number of reasons, which can be remember using the acronym P-CAFÉ:

- **Planning** – Budgeting is essentially about financial planning. Business strategy and operations cannot happen without the necessary finances. Budgeting helps managers to plan their operations and strategies based on the available finances in the budget.
- **Contingency planning** – Budgeting allows a business to plan to put aside money for emergency use. This helps a business to be better prepared for any unexpected costs or unplanned expenditure. In the worst case scenario, effective budgeting can help a business during a crisis situation.
- **Accountability** – Budgets limit how much money can be spent on certain business operations, thereby making people accountable for their decisions and expenditure. Budgeting helps to ensure that money is not wasted on non-essential items.
- **Financial control** – Budgeting enables managers to better understand possible financial problems in order to take corrective measures. This is particularly important in large organizations that consist of many people and different departments, preventing costs from spiralling out of control.
- **Efficiencies** – Budgeting forces businesses to prioritise their items of expenditure in order to achieve the organization's goals. Decision makers are more careful with their budgets, thus make efficiency gains for the business. For example, there is an incentive for the firm to find new suppliers, which helps to save money and operate within budget constraints.

Budgets and variance analysis have an important role in decision-making. There are several reasons for this:

- Financial planning – Budgets are a quantitative management tool used to plan business spending in a coordinated and transparent way, across all different departments within the organization. Budgets (and variance analysis) help to define organizational objectives, thereby forcing managers to plan ahead.
- Financial control – Budgets and variance analysis help a business to have better control over its spending, by comparing actual and budgeted expenditure. Comparisons can also be made between the different costs and/or revenues of different departments. Historical comparisons can also be made. Such comparisons make managers more accountable for their actions.
- Flexibility – However, budgets do not have to be rigid. A persistent variance is can be proof that strategic planning needs to change, i.e., budgets need to be revised in order to achieve the firm's strategic plan. Positive variances can also signify a chance in strategy, such as allocating more financial resources to advertising and promotion for products that outperform initial forecasts.
- Financial prudence – Budgets and variance analysis help to ensure that the financial costs of any business decision are accurately considered. For example, variance analysis can highlight any repeated inaccuracies in the budget, which can cause cash shortages for the business. It can then respond by introducing strategies to boost revenues and/or cut back expenditure.
- Accountability – Budgets and variance analysis can be powerful tools to measure the effectiveness of different managers. Their strategic decision making can be questioned if budgets are not well managed. Alternatively, if they operate within their allocated budgets and meet or exceed organizational goals, they can be suitably rewarded.

Business Management Toolkit (BMT) - Hofstede's cultural dimensions

Discuss how the culture within an organization impacts its approach to budgets and budgeting.

You might wish to refer to Unit 2.5 Organizational (corporate) culture (HL only) as well as Hofstede's cultural dimensions (HL only) prior to answering the above question.

Teacher only box

Notes for consideration:

The way in which budgets are used largely depends on the firm’s organizational culture. Organizations that adopt an authoritarian culture tend to be arranged by a tightly controlled budgetary system, such as a zero budgeting arrangement. Targets might also be imposed upon budget holders without any discussion or negotiation. Budget holders are likely to be held accountable for all variance, no matter how minor these might be.

Another example is that budgeting process can be detrimental to organizational culture. It may limit cooperation and cohesion between departments as they compete to improve their own budgets (to enhance their own status and protect their own self-interest) at the expense of other departments. Therefore, such an internally competitive culture is harmful to the overall success of the business.

By contrast, organizations that have an open and entrusting culture tend to use budgets as a form of empowerment and motivation. Budget holders are likely to be held accountable for all variance, no matter how minor these might be.