



Benefits and Limitations

Budgeting plays a key role in the effective use of resources and achieving overall organizational goals.

Organizations decide how they should act in a certain environment. What distinguishes them is the intensity and anticipation of the decision-making process.

In its strategic planning process, a company decides in year 0 what products or services will be launched in year 1, how much supplies will it use, the amount to be paid in wages, investments and so on. In other words, the strategic planning and what needs to be done in year one must be done in advance to succeed and achieve the goals in an effective way. Even when the timing is very short term, almost immediately before the implementation, some effort regarding budgeting is necessary. You have to be prepared to support the improvement of the products, services, and business units expenditures.

We can list numerous of reasons why budgeting is a benefit and a powerful tool for management. Budgeting provides a precious means of controlling income and expenditure as a plan for investments and expenses. It helps organizations in coordinating how to direct resources into the most profitable initiatives.

The budgeting process in organization develops an attitude of expenditure consciousness, stimulating the efficient use of resources, and creating an environment of profit-mindedness throughout the organization. It emphasizes how much should be spent to achieve a goal. The process also provides a tool through which managerial policies and goals are periodically evaluated, tested and established as guidelines for the entire organization, encouraging productive competition, provides an incentive to perform efficiently and gives a sense of responsibility to everyone in the organization. All these positive factors lead to higher output and increase productivity.

For management, budgeting helps to generate a sense of caution and care, and they make adequate study among managers before decisions. But what would be the advantage in deciding advance? To answer this question, we listed some significant benefits following:

- **Bring more transparency:** Budgeting can bring more transparency between the company's areas during the process because it encourages the debate and brings interdependencies to the light, which aligns mutual concerns and expectations and promotes synergy. It leads the organization to achieve the objectives and also potentialize the collaboration between areas.

- **Coordination of areas' activities:** The mutual alignment between the areas during the budgeting process also collaborates for a better coordination of the resources toward the goals. If increasing the sales is a company's goal, supply chain, production, marketing and other areas need to coordinate all effort to achieve it efficiently and competitively. It can be done more easily with a budgeting planning.
- **Early Decisions:** As in any situation, a proper time to think and mature one decision is something important. It allows identifying new perspectives, new approaches and improves some managers' knowledge due to the enrichment provided by information and analysis. In this sense, the budgeting planning takes to the decision making in advance. It is critical to the business development, avoiding situations where the organization can not reach the goals due to lack of planning and resources.
- **Commitment:** Involving everyone who has an influence directly in the results is necessary because it can develop a sense of responsibility and commitment to them once they make part of the process and decision making. Everyone involved in the budgeting has to commit to the plan and the results in which it proposes because it was built through their support. The budgeting planning must be recognized by everyone in the organization as fair and feasible especially for those who the performance will be compared to the company's goals. During the process, listening to all involved potentialize their commitment and lead to greater success.
- **Responsibility definition to accountability:** The budgeting planning demands a definition of responsibilities whether by area or business unit depending on the organization's structure. Without this definition, the accountability wouldn't be possible because both authority and collection of results can not be exercised.
- **Efficiency:** Once developed the budgeting planning, there is not only the financial evaluation implementation but also of the whole business, where adequate levels of performance are pursued. Economic and operational indicators should be identified and monitored with determined frequency. Inadequate performance should be addressed and avoided at the planning stage since control assumes that the planned efficiency level should be achieved.
- **Performance evaluation:** The management of any organization should not consider the results achieved as better or worse by comparison with the previous years, but it must be done compared to the budget. All responsible involved in the process should analyze the performance by comparing actual versus budget. The results of this analysis give inputs regarding how the organization is progressing toward the goals. Managers can also evaluate their decisions and achievements and take suitable actions to improve their performances.
- **Predicting financial indicators such as profitability, cash flow, cash allocation and cost reduction:** The daily activities could easily make managers lose the focus where the company makes money. In this context, a properly structured budget can pinpoint cash inflow drivers and cash outflow drivers. It means that the management team can examine whether it should drop some part of the business or expand in others. Also, budgeting is helpful to predict cash flow considering the receivables, sales patterns, company's growth and seasonality. The cash allocation has an impact on cash flow as well, which makes the process of budget consider it. As long as the resources available are limited, determine how to allocate it is an important task in the process. Managers must decide which assets are most worth to invest and predict it on the budget. And last but not least, budgeting helps to designate cost reduction targets that the company wishes to pursue.
- **Assumptions review:** The budgeting planning leads management to think about how the company is in its business and the assumptions about the business environment in which it is inserted. During the process, a re-evaluation regarding this issues can result in turn alter the way in which the managers decide to conduct the business.



On the other hand, Budgeting has certain limitations and disadvantages which require careful consideration. Barriers to effective budgeting including the following reason:

The success and utility of budgeting depend on the cooperation and participation of all members of management. All involved should direct their efforts according to the plan. Many a time budgeting failures are due to the managers lack commitment.

A budget is only a tool. Managers should use it for accomplishing their functions. Sometimes managers fail to understand that budget is meant to provide detailed information, goals, and targets which may help them in resource allocation decisions and achieve the company objectives.

Sometimes organizations expected too much from a budget and in the case of the expectations are not fulfilled, the culprit is the budget. But do not forget: It's only a tool. All involved in the budget process are responsible for its results.

Budgeting is not an exact science. Do not expect an unfailing budget plan. It uses approximations and judgment which may not be 100% accurate. At best, a budget is an estimate, and no one knows for sure what could happen in the future.

There are too many situations where the budgeting planning process could spend a lot of time and energy from management. In poor-organized structures, the interactions between areas could be harder to reach, and it will take a significant time to align and coordinate the interdependencies and necessities. In organizations with a high amount of data available, managers tend to spend too much time discussing information and manipulating inadequate toolsets to deliver forecasts and budgets objectives. Large businesses usually to dedicated a whole department to budget setting and control. Consuming too much time in the process could be a trap, and all involved in the process must be aware to avoid it.

Another menace to organizations happens when management does not understand the principles of budgeting and attempt to introduce a budgetary slack, which involves deliberately reducing revenues estimates and increasing expenditures estimates to achieve favorable results when compared to what was planned in the budget. Sometimes, managers engage in "games to protect their fiefdoms" against the anticipated reductions.

After de budgeting planning, some decision making could become inflexible. The budgeting planning process tends to focus the management attention in a particular period, usually before the end of the fiscal year. Due to a lack of a formal review process during the rest of the year, some companies lose the chance to analyze environmental changes and external factors which could impact the companies' performance and adjust some budget objectives aligning it with the new market reality.

One of the most common limitations of budgeting is its quantitative nature, which leads management to focus almost exclusive in some aspects of business, such as improving or maintaining profitability and other financial outcomes.

There are more variables and aspects which can be a limitation or disadvantage for the budgeting planning. We mentioned the most common issues.



Did you like this lesson? If you like the subject and want to go further on the topic, you can find below our references.

Sources

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