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ACCOUNTING & AUDIT

The Disadvantages of Budgeting

A budget is based on a set of assumptions that are generally not too far distant from the operating conditions under which it was formulated.

Bethany O'Hoyt • Jan. 29, 2014

On the CPE Link Blog, we've discussed the [Advantages of Budgeting](#), yet we did not discuss the number of serious disadvantages. This article gives an overview of the general issues, while the following sections address the particular problems associated with capital budgeting, as well as the use of budgets within a command and control management system.

- **Inaccuracy.** A budget is based on a set of assumptions that are generally not too far distant from the operating conditions under which it was formulated. If the business environment changes to any significant degree, then the company's revenues or cost structure may change so radically that actual results will rapidly depart from the expectations delineated in the budget. This condition is a particular problem when there is a sudden economic downturn, since the budget authorizes a certain level of spending that is no longer supportable under a suddenly reduced revenue level. Unless management acts quickly to override the budget, managers will continue to spend under their original budgetary authorizations, thereby rupturing any possibility of earning a profit. Other conditions that can also cause results to vary suddenly from budgeted expectations include changes in interest rates, currency exchange rates, and commodity prices.

- ***Rigid decision making.*** The budgeting process only focuses the attention of the management team on strategy during the budget formulation period near the end of the fiscal year. For the rest of the year, there is no procedural commitment to revisit strategy. Thus, if there is a fundamental shift in the market just after a budget has been completed, there is no system in place to formally review the situation and make changes, thereby placing a company at a considerable disadvantage to its more nimble competitors.
- ***Time required.*** It can be very time-consuming to create a budget, especially in a poorly-organized environment where many iterations of the budget may be required. The time involved is lower if there is a well-designed budgeting procedure in place, employees are accustomed to the process, and the company uses budgeting software. The work required can be more extensive if business conditions are constantly changing, which calls for repeated iterations of the budget model.
- ***Gaming the system.*** An experienced manager may attempt to introduce budgetary slack, which involves deliberately reducing revenue estimates and increasing expense estimates, so that he can easily achieve favorable variances against the budget. This can be a serious problem, and requires considerable oversight to spot and eliminate.
- ***Blame for outcomes.*** If a department does not achieve its budgeted results, the department manager may blame any other departments that provide services to it for not having adequately supported his department.
- ***Expense allocations.*** The budget may prescribe that certain amounts of overhead costs be allocated to various departments, and the managers of those departments may take issue with the allocation methods used. This is a particular problem when departments are not allowed to substitute services provided from within the company for lower-cost services that are available elsewhere.
- ***Use it or lose it.*** If a department is allowed a certain amount of expenditures and it does not appear that the department will spend all of the funds during the budget period, the department manager may authorize excessive expenditures at the last minute, on the grounds that his budget manager may authorize excessive expenditures at the last minute, on the grounds that his budget tends to make managers believe that they are entitled to a certain amount of funding each year, irrespective of their actual need for the funds.
- ***Only considers financial outcomes.*** The nature of the budget is numeric, so it tends to focus management attention on the quantitative aspects of a business; this usually means an intent focus on improving or maintaining profitability. In reality, customers do not care about the profits of a business – they will only buy

from the company as long as they are receiving good service and well-constructed products at a fair price. Unfortunately, it is quite difficult to build these concepts into a budget, since they are qualitative in nature. Thus, the budgeting concept does not necessarily support the needs of customers.

The discussion of budgeting has cast serious doubts on the need for a detailed and rigorously-enforced budgeting system, especially one that integrates the budget model with bonus plans. Nonetheless, the decision to install a budget is up to the reader.

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