6 Budget Setting Techniques – Explained

The key to effective budgetary control is the budget setting process. Budgets should accurately reflect the service being provided and there are a number of budget setting techniques that can be applied to both expenditure and income budgets. They can be used independently or combined depending on the type of budget being set. The crucial techniques include:

1. Incremental Budgeting
2. Zero Based Budgeting
3. Cash Limited Budgeting
4. Resource Restricted Budgeting
5. Activity Based Budgeting
6. Contingency Budgeting

Incremental Budgeting

This technique relies on using an historic base as a starting point for budget setting. This is often the budget or the actual figures for the previous year, or some combination of the two. The base is then used to formulate the budget for the following year by taking each budget heading and either adding or subtracting an inflation factor from the base figures and adjusting for other known factors such as savings or approved growth.

Advantages

- Simple
- Quick
- Accurate, if little change in activity

Dis-Advantages

- Historic
- No account taken of necessary future changes
- Assumes the base is accurate
- Compounds historic errors

Incremental budgeting is best used for certain items of expenditure which are unlikely to change from year to year. For example, when staffing remains constant, salaries can be budgeted for incrementally where the increment reflects the pay award, or in the case of fixed price contracts there may be an agreed annual inflation rate.

Zero Based Budgeting

This approach to budget setting is most strongly recommended as it is linked to the business planning process. The zero based budget assumes that all budgets are derived from first principles and that the organisation can start with a blank piece of paper; a zero base. They are based on the objectives to be achieved for the period without necessarily referring to the past.

Advantages

- Pro-active and forward looking
- Realistic and accurate
- Links into business plans

Dis-Advantages

- Time consuming
- Requires clear objectives
- Many organisations cannot begin with a zero base as they have committed expenditure on existing staff, buildings and contracts, which they are obliged to continue, at least in the short term.

It is generally considered the advantages of zero based budgeting outweigh the dis-advantages. Where possible, zero based principles should be adopted, even when in most instances an organisation will not have a totally zero base to begin with.

Cash Limited Budgeting

This technique is appropriate when the service area is given a set limit on its total net expenditure. The service manager then has to determine what can be delivered within this cash limit and create a budget accordingly. This technique can prove difficult if the service objectives give targets on output without reference to the practicality of meeting those targets within a cash limit. The approach to be used in the case of cash limited budgets is to identify the costs that are fixed, i.e. those that cannot be reduced, and then to spread the balance of the budget across those items which are variable and have an element of flexibility.

Advantages

- Clear parameters on expenditure
- Quick - negotiation limited
- Incentive to make savings to bring expenditure in line with cash limit

Dis-Advantages

- Services may have to decrease quality or quantity (or both) in order to stay within the cash limit
- Not necessarily linked to business objectives which may include a need for change or development
- Assumes there is sufficient flexibility in the budget to operate within an overall cash limit
- Inflexible - not practical for demand led/statutory services

Resource Restricted Budgeting

This type of budgeting occurs when resources to be utilised by the service are restricted. Resource restriction will typically relate to:

- *Staff*
- *Equipment*
- *Property*
- *Finance*
  (the cash limited budget is a form of resource restricted budget)

There are often many reasons why resources need to be restricted. For example, it may be necessary for the benefit of the whole organisation to restrict staff numbers. This action may be required because recruiting an additional full time member of staff represents an on-going future commitment which the organisation may not be able to sustain. Hence, restricting the staffing resource is a common budget setting approach.

Advantages

- Clear parameters on expenditure
- Quick - negotiation limited
- Organisation maintains strong control over its resources

Dis-Advantages

- No consideration of the practical impact of restricting resources and the effect on services
- Not linked to business objectives which may include a need for change or development
- Inflexible - not practical for demand led/statutory services

Activity Based Budgeting

The organisation using this approach sets budgets based on the cost of providing each area of activity. If the budget has to be reduced, each activity should be examined, and decisions made as to which should cease or reduce accordingly. This method of budgeting is only possible if there are clear divisions between each activity, and where resources can be separately allocated. Where resources are shared (such as staff, premises, etc.) the scope for activity based budgeting is more difficult. It then relies on accurate resource allocation methods, such as time charging by staff, allocating square footage, and utility usage, etc. to individual activities.

Advantages

- Resources clearly matched to service provision
- Forms a base for unit costing
- Highlights which are the most expensive activities

Dis-Advantages

- Resource allocation may not be accurate

- Can be complex to calculate as detailed work needs to be undertaken to isolate each activity and the resources consumed
- Not practical for services where a flexible approach needs to be taken and where resources need to be moved between activities in response to demand

Contingency Budgeting

This budgeting technique is sometimes seen as "a broad brush" approach. Limited effort is used to establish detailed estimates for each of the budget headings as a contingency amount is provided to take account of poor estimates, changes in demand, and insufficient resources. The contingency may be used flexibly across any of the budget headings. The level of the contingency will depend on an estimation of the risk of error within the budget. If it is considered that the budget has been calculated to an accuracy level of 80%, then a 20% contingency may be added to the budget.

Advantages

- Quick
- Easy
- Flexible

Dis-Advantages

- Inaccurate; open to guess work
- Insufficient thought given to linking service with finance
- Will be difficult to monitor

What Next?

One of the keys to budget setting is to understand the budget drivers of the service or activity being undertaken. These are the input elements that drive the expenditure or income, and hence the budget. Understanding budget drivers enables budget holders to begin the creative thinking and implement control.

Using the correct budget setting techniques is crucial for setting realistic budgets. Learn more about the above with illustrated examples by reading our book, "Managing the Devolved Budget".