Bottom Up Budgeting Vs Top Down Budgeting: Pros and Cons



Top-Down Budgeting Versus Bottom-Up Budgeting: Which One Is Best for Your Business?

One thing that financial experts agree on is the importance of creating a business budget.

Whether you're a sole proprietor starting a brand-new business, or an international business with locations worldwide, creating a budget is a necessity.

What are the benefits of creating a budget?

Yes, you can run your business without a budget. But doing so brings a lot of risks, including overspending and poor cash flow.

The following are just a few of the benefits of creating a budget.

1. **Increased efficiency –** Creating a budget allows you to look past the immediate and focus on the long-term health of your business. For example, many businesses that collect the majority of their revenue during the summer months often wait until then to schedule maintenance and repairs. Creating a budget provides you with a look at all of the months down the road, allowing you to create a more accurate forecasting model, which in turn will allow you to operate more efficiently.
2. **Planning for profit –** Creating a budget can help you better plan for profit. Budgeting all known expenses along with some unexpected ones gives you a much clearer idea of just how much revenue you need to bring in to become profitable. If you know that you have $24,000 in regular expenses for the month and wish to maintain a profit margin of at least 10%, you'll know that you need to earn at least $26,400 for that month to maintain your desired profit margin.
3. **Better business management –** Long-term planning is a necessity for business owners. For example, if you want to grow your business, creating a budget for the next five years can help you immediately and long-term. If your goal is to increase revenue by 15% yearly, creating a budget that outlines not only those estimated increases, but expected expenses can provide a blueprint for success.

What type of budget should I use?

For smaller businesses, a general budget is adequate, However, if your business has multiple departments and management levels, your budgeting approach will need to be different.

If a general budget is no longer adequate for your business, you'll need to decide between preparing a Top-Down Budget or a Bottom-Up budget.

While both budgets can be useful, the preparation process is very different for each, with advantages and disadvantages to both.

What is a Top-Down Budget?

A top-down budget is a budget prepared by senior management.

Most large corporations use a top-down budget, where management prepares a high-level budget across the entire organization with certain amounts allocated to each department.

Once the department heads are provided with their allocated totals, they prepare their departmental budget.

The top-down approach looks at the previous year's budget along with current business trends, and growth strategies. This information is later used when setting the goals and objectives for the various departments and the organization as a whole.

There are several advantages and disadvantages of using the top-down budget method.

Top-Down Budgeting Process	
Advantages	**Disadvantages**
Focuses more on organizational growth	May not provide enough detail
A more expedited process	Can create unrealistic expectations
Provides clear expectations to departments	May cause resentment in lower management
Time-saver for upper and lower level management	Less accurate

A top-down budget can give department heads and team members a clear picture of upper management expectations and where they wish to take the business.

For example, James is the CEO of a mid-sized manufacturing company. As an active participant in the creation of a top-down budget, James will first take a look at company goals before looking at pricing, revenue streams, and expenses across the organization.

If James decides he wants to add another operational unit or start manufacturing different products, he can create a budget that reflects the associated costs of doing so, something that cannot be done by department managers.

Another advantage to using a top-down budget is that it typically takes less time

to prepare a top-down budget than it does to prepare a bottom-up budget, since there are fewer departments involved, making it a time-saver for everyone involved in the budget preparation process.

A top-down budget can also be helpful to department heads when preparing their budgets, making them aware of both possibilities and limitations presented in the budget.

However, there are disadvantages of top-down budgeting. Since top-down budgets look at the big picture, they may not provide department managers with the details they need to create their budget.

Furthermore, a top-down budget may create unrealistic expectations for department heads to adhere to since they weren't involved in the creation process, with many details overlooked or eliminated.

Accuracy can also be an issue, with top-down budgets usually eliminating many of the details that a bottom-up budget can provide.

And finally, a top-down budget may create some resentment in department heads as they were not involved in the preparation process.

> *As you add more levels of management, you'll want to incorporate bottom-up budgeting, which provides a level of detail that a top-down budget does not. A bottom-up budget also provides upper management with departmental details that they may be unaware of.*

The Process of creating a top-down budget

The process of creating a top-down budget is fairly straightforward and involves the following steps.

Step 1

Top-level management meets to set sales and expense targets for the upcoming year.

Because this is high-level budgeting, upper management is not concerned with specific line items but concentrates on expected performance for the entire company.

Step 2

Once the preliminary budgeting process is completed, the finished document is sent to the finance department, where they will review the document and create a budget allocation for each department within the organization.

Step 3

Each department manager is informed about the total money allocated to their department. Once this information is received, they prepare a detailed budget for their department, involving other staff as necessary.

Step 4

Once the department budget has been completed, managers return it to the finance/accounting department, where it is reviewed and approved.

Step 5

Once approved, all of the department budgets are combined to form a single organizational budget.

At that point, it’s up to each department manager to run a monthly budget vs. actual report to determine how under or over budget the department is.

What is a Bottom-Up Budget?

A bottom-up budget is the exact opposite of a top-down budget, involving department heads and other staff from the start.

Even though a top-down budget can be a time-saver, a bottom-up budget is frequently seen as more accurate, since department heads know much more about their department than upper management does.

Rather than looking at the big picture, a bottom-up budget relies on individual

departments or teams to create their budgets, which provide a level of detail that a top-down budget does not.

Once a bottom-up budget is completed, the budget is forwarded to upper management, where they will look over the budget, make suggestions for changes, and finally, approve the budget for the next year.

Bottom-Up Budgeting Process	
Advantages	**Disadvantages**
More accurate budget estimates	Limited involvement on the executive level
Involvement at all levels	Can miss the big picture
Morale booster	Time-consuming process
Higher level of commitment	It may be too lenient

There are numerous advantages to bottom-up budgeting, starting with accuracy. No one knows the ins and outs of a department better than its managers, particularly when it comes to estimating future costs and resources. For example, Bonnie is the head of her department.

She’s aware of two employees that have been having issues coming to work regularly, with most of their work usually completed by other staff members.

What this has shown Bonnie is that she can likely terminate one or both of the errant employees and replace them with one person if necessary.

Armed with that knowledge, Bonnie can use that information when creating her department budget, which will reflect changes in her department’s salary expenses.

And because of that reduction, she can also add in raises for her other employees. This is something that upper management would likely be unaware of.

Another advantage of a bottom-up budget is that it serves as a morale booster to those involved in the budget preparation process, knowing that their input is valued.

Finally, when employees play a role in preparing their own budget, it’s much more likely that they’ll stick to it.

While there are a lot of advantages to using bottom-up budgeting, there are some disadvantages as well.

One of the most prominent is the limited involvement of upper-level management.

While some may see this as an advantage, many upper-level executives may view it as exclusionary.

Another big disadvantage is that departmental budgets are often created in a silo, with little consideration for the big picture.

The process of creating a bottom-up budget

A more time-consuming process than a top-down budget, creating a bottom-up budget requires a commitment from numerous staff members.

Here are the steps you can follow to create a bottom-up budget for your business.

Step 1

Identify all departments within your organization.

If you have multiple levels of management within each department, be sure that they are included in the budgeting process as well.

Step 2

Once the budget preparers have been identified, they will need to make a list of all expected expenditures for the upcoming year.

This will need to include recurring expenses such as salaries, office supplies, postage and printing costs, dues and subscriptions, and travel.

It’s also important to include any one-time expenses that may be incurred in the upcoming year, such as replacing outdating computer equipment or buying a new office printer.

Step 3

When the department budget is completed, it should be forwarded to upper management for approval.

Once approved, all departmental budget totals are combined to create a single organizational budget.

In many cases, upper management may send a budget back to the different departments for adjustments, particularly if expenses are deemed too high.

Step 4

Once changes have been made, the budget is then sent back to upper management for final approval.

Once approved, a final budget is prepared, with each department head provided with their departmental budget.

Which budgeting option is right for your business?

For smaller businesses with a limited number of departments, it makes more sense to use top-down budgeting, since upper management are likely more concerned with company growth and expansion.

In addition, top-down budgeting can be used to create a financial plan that addresses more of the concerns of small businesses, such as adequate cash flow, areas where the business can expand, and areas where expenses may need to be reduced.

As you add more levels of management, you'll want to incorporate bottom-up budgeting, which provides a level of detail that a top-down budget does not.

A bottom-up budget also provides upper management with departmental details that they may be unaware of.

Whichever budget you choose to prepare for your business, it's always wise to keep the channels of communication open between upper, mid-level, and lower

management, particularly in the decision-making process.

That way, you're likely to end up with an overall budget that can serve as a valuable resource for your business now and for years to come.

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