The What and Why of Budgeting

An Introduction

A budget is defined as the formal expression of plans, goals, and objectives of management that covers all aspects of operations for a designated time period. The budget is a tool providing targets and direction. Budgets provide control over the immediate environment, help to master the financial aspects of the job and department, and solve problems before they occur. Budgets focus on the importance of evaluating alternative actions before decisions actually are implemented.

A budget is a financial plan to control future operations and results. It is expressed in numbers, such as dollars, units, pounds, hours, manpower, and so on. It is needed to operate effectively and efficiently. Budgeting, when used effectively, is a technique resulting in systematic, productive management. Budgeting facilitates control and communication and also provides motivation to employees.

Budgeting allocates funds to achieve desired outcomes. A budget may span any period of time. It may be short term (one year or less, which is usually the case), intermediate term (two to three years), or long term (three years or more). Short-term budgets provide greater detail and specifics. Intermediate budgets examine the projects the company currently is undertaking and start the programs necessary to achieve long-term objectives. Long-term plans are very broad and may be translated into short-term plans. The budget period varies according to its objectives, use, and the dependability of the data used to prepare it. The budget period is contingent on business risk, sales and operating stability, production methods, and length of the processing cycle.

There is a definite relationship between long-range planning and short-term business plans. The ability to meet near-term budget goals will move the business in the direction of accomplishing long-term objectives. Budgeting is done for the company as a whole, as well as for its component segments including divisions, departments, products, projects, services, manpower, and geographic areas.
Budgets aid decision making, measurement, and coordination of the efforts of the various groups within the entity. Budgets highlight the interaction of each business segment to the whole organization. For example, budgets are prepared for units within a department, such as product lines; for the department itself; for the division, which consists of a number of departments; and for the company.

Master (comprehensive) budgeting is a complete expression of the planning operations of the company for a specific period. It is involved with both manufacturing and nonmanufacturing activities. Budgets should set priorities within the organization. They may be in the form of a plan, project, or strategy. Budgets consider external factors, such as market trends, economic conditions, and the like. The budget should list assumptions, targeted objectives, and agenda before number crunching begins.

The first step in creating a budget is to determine the overall or strategic goals and strategies of the business, which are then translated into specific long-term goals, annual budgets, and operating plans. Corporate goals include earnings growth, cost minimization, sales, production volume, return on investment, and product or service quality. The budget requires the analysis and study of historical information, current trends, and industry norms. Budgets may be prepared of expected revenue, costs, profits, cash flow, production purchases, net worth, and so on. Budgets should be prepared for all major areas of the business.

The techniques and details of preparing, reviewing, and approving budgets varies among companies. The process should be tailored to each entity’s individual needs. Five important areas in budgeting are planning, coordinating, directing, analyzing, and controlling. The longer the budgeting period, the less reliable are the estimates.

Budgets link the nonfinancial plans and controls that constitute daily managerial operations with the corresponding plans and controls designed to accomplish satisfactory earnings and financial position.

Effective budgeting requires the existence of:

- Predictive ability
- Clear channels of communication, authority, and responsibility
- Accounting-generated accurate, reliable, and timely information
- Compatibility and understandability of information
- Support at all levels of the organization: upper, middle, and lower

The budget should be reviewed by a group so that there is a broad knowledge base. Budget figures should be honest to ensure trust between the parties. At the corporate level, the budget examines sales and production to estimate corporate earnings and cash flow. At the department level, the budget examines the effect of work output on costs. A departmental budget shows resources available, when and how they will be used, and expected accomplishments.

Budgets are useful tools in allocating resources (e.g., machinery, employees), making staff changes, scheduling production, and operating the business. Budgets
help keep expenditures within defined limits. Consideration should be given to alternative methods of operations.

Budgets are by departments and responsibility centers. They should reflect the goals and objectives of each department through all levels of the organization. Budgeting aids all departmental areas including management, marketing, personnel, engineering, production, distribution, and facilities.

In budgeting, consideration should be given to the company’s manpower and production scheduling, labor relations, pricing, resources, new product introduction and development, raw material cycles, technological trends, inventory levels, turnover rate, product or service obsolescence, reliability of input data, stability of market or industry, seasonality, financing needs, and marketing and advertising. Consideration should also be given to the economy, politics, competition, changing consumer base and taste, and market share.

Budgets should be understandable and attainable. Flexibility and innovation is needed to allow for unexpected contingencies. Flexibility is aided by variable budgets, supplemental budgets, authorized variances, and review and revision. Budgets should be computerized to aid “what-if” analysis. Budgeting enhances flexibility through the planning process because alternative courses of action are considered in advance rather than forcing less-informed decisions to be made on the spot. As one factor changes, other factors within the budget will also change. Internal factors are controllable by the company whereas external factors usually cannot be controlled. Internal factors include risk and product innovation.

Forecasting is predicting the outcome of events. It is an essential starting point for budgeting. Budgeting is planning for a result and controlling to accomplish that result. Budgeting is a tool, and its success depends on the effectiveness to which it is used by staff. In a recessionary environment, proper budgeting can increase the survival rate. A company may fail from sloppy or incomplete budgeting. Exhibit 1.1 shows a graphic depiction of budget segments.

We now consider planning, types of budgets, the budgetary process, budget coordination, departmental budgeting, comparing actual to budgeted figures, budget revision and weaknesses, control and audit, participative budgeting, and the pros and the cons of budgets.

**Planning**

Budgeting is a planning and control system. It communicates to all members of the organization what is expected of them. Planning is determining the activities to be accomplished to achieve objectives and goals. Planning is needed so that a company can operate its departments and segments successfully. It looks at what should be done, how it should be done, when it should be done, and by whom. Planning involves the determination of objectives, evaluating alternative courses of action, and authorization to select programs. There should be a good interface of segments within the organization.

Budgets are blueprints for projected action and a formalization of the planning process. Plans are expressed in quantitative and monetary terms. Planning is
taking an action based on investigation, analysis, and research. Potential problems are searched out. Budgeting induces planning in each phase of the company’s operation.

A profit plan is what a company expects to follow to attain a profit goal. Managers should be discouraged from spending their entire budget. Managers should be given credit for cost savings.

Budget planning meetings should be held routinely to discuss such topics as the number of staff needed, objectives, resources, and time schedules. There should be clear communication of how the numbers are established and why, what assumptions were made, and what the objectives are.

Types of Budgets

It is necessary to be familiar with the various types of budgets to understand the whole picture and how these budgets interrelate. The types of budgets include master, operating (for income statement items comprised of revenue and expenses), financial (for balance sheet items), cash, static (fixed), flexible, capital expenditure (facilities), and program (appropriations for specific activities such as research and development, and advertising). These budgets are briefly explained below.
Master Budget

A master budget is an overall financial and operating plan for a forthcoming calendar or fiscal year. It is usually prepared annually or quarterly. The master budget is really a number of subbudgets tied together to summarize the planned activities of the business. The format of the master budget depends on the size and nature of the business.

Operating and Financial Budgets

The operating budget deals with the costs for merchandise or services produced. The financial budget examines the expected assets, liabilities, and stockholders’ equity of the business. It is needed to see the company’s financial health.

Cash Budget

The cash budget is for cash planning and control. It presents expected cash inflow and outflow for a designated time period. The cash budget helps management keep cash balances in reasonable relationship to its needs and aids in avoiding idle cash and possible cash shortages. The cash budget typically consists of four major sections:

1. Receipts section, which is the beginning cash balance, cash collections from customers, and other receipts
2. Disbursement section, comprised of all cash payments made by purpose
3. Cash surplus or deficit section, showing the difference between cash receipts and cash payments
4. Financing section, providing a detailed account of the borrowings and repayments expected during the period

Static (Fixed) Budget

The static (fixed) budget is budgeted figures at the expected capacity level. Allowances are set forth for specific purposes with monetary limitations. It is used when a company is relatively stable. Stability usually refers to sales. The problem with a static budget is that it lacks the flexibility to adjust to unpredictable changes.

In industry, fixed budgets are appropriate for those departments whose workload does not have a direct current relationship to sales, production, or some other volume determinant related to the department’s operations. The work of the departments is determined by management decision rather than by sales volume. Most administrative, general marketing, and even manufacturing management departments are in this category. Fixed appropriations for specific projects or programs not necessarily completed in the fiscal period also become fixed budgets to the extent that they will be expended during the year. Examples are appropriations for...
capital expenditures, major repair projects, and specific advertising or promotional programs.

**Flexible (Expense) Budget**

The flexible (expense) budget is most commonly used by companies. It allows for variability in the business and for unexpected changes. It is dynamic in nature rather than static. Flexible budgets adjust budget allowances to the actual activity. Flexible budgets are effective when volumes vary within a relatively narrow range. They are easy to prepare with computerized spreadsheets such as Excel.

The four basic steps in preparing a flexible (expense) budget are:

1. Determine the relevant range over which activity is expected to fluctuate during the coming period.
2. Analyze costs that will be incurred over the relevant range in terms of determining cost behavior patterns (variable, fixed, or mixed).
3. Separate costs by behavior, determining the formula for variable and mixed costs.
4. Using the formula for the variable portion of the costs, prepare a budget showing what costs will be incurred at various points throughout the relevant range.

Due to uncertainties inherent in planning, three forecasts may be projected: one at an optimistic level, one at a pessimistic or extremely conservative level, and one at a balanced, in-between level.

**Capital Expenditure Budget**

The capital expenditure budget is a listing of important long-term projects to be undertaken and capital (fixed assets such as plant and equipment) to be acquired. The estimated cost of the project and the timing of the capital expenditures are enumerated along with how the capital assets are to be financed. The budgeting period is typically for 3 to 10 years. A capital projects committee, which is typically separate from the budget committee, may be created solely for capital budgeting purposes.

The capital expenditures budget often classifies individual projects by objective, as for

- Expansion and enhancement of existing product lines
- Cost reduction and replacement
- Development of new products
- Health and safety expenditures

The lack of funds may prevent attractive potential projects from being approved.
An approval of a capital project typically means approval of the project in principle. However, final approval is not automatic. To obtain final approval, a special authorization request is prepared for the project, spelling out the proposal in more detail. The authorization requests may be approved at various managerial levels depending on their nature and dollar magnitude.

**Program Budget**

Programming is deciding on the programs to be funded and by how much. A common application of program budgets is to product lines. Resources are allocated to accomplish a specific objective with a review of existing and new programs. Some suitable program activities include research and development, marketing, training, preventive maintenance, engineering, and public relations. Funds usually are allocated based on cost effectiveness. In budget negotiations, proposed budgetary figures should be explained and justified. The program budget typically cannot be used for control purposes because the costs shown cannot ordinarily be related to the responsibilities of specific individuals.

Depending on needs and convenience, budgets can be classified as incremental, add-on, supplemental, bracket, stretch, strategic, activity-based, target, and/or continuous.

**Incremental Budget**

Incremental budgeting looks at the increase in the budget in terms of dollars or percentages without considering the whole accumulated body of the budget.

There are also self-contained, self-justified increments of projects. Each one specifies resource utilization and expected benefits. A project may be segregated into one or more increments. Additional increments are required to complete the project. Manpower and resources are assigned to each increment.

**Add-on Budget**

An add-on budget is one in which previous years’ budgets are examined and adjusted for current information, such as inflation and employee raises. Money is added to the budget to satisfy the new requirements. With add-on, there is no incentive for efficiency, but competition forces one to look for new, better ways of doing things. For example, Konica Imaging U.S.A. has combined add-on with zero-based review.

**Supplemental Budget**

Supplemental budgets provide additional funding for an area not included in the regular budget.
Bracket Budget

A bracket budget is a contingency plan where costs are projected at higher and lower levels than the base amount. Sales are then forecasted for these levels. The purpose of this method is that if the base budget and the resulting sales forecast is not achieved, the bracket budget provides management with a sense of earnings impact and a contingency expense plan. A contingency budget may be appropriate when there are downside risks that should be planned for, such as a sharp drop in revenue.

Stretch Budget

A stretch budget may be considered a contingency budget on the optimistic side. Typically it is only confined to sales and marketing projections that are higher than estimates. It is rarely applied to expenses. Stretch targets may be held informally without making operating units accountable for them. Alternatively, stretch targets may be official estimates for sales/marketing personnel. Expenses may be estimated at the standard budget sales target.

Strategic Budget

Strategic budgeting integrates strategic planning and budgeting control. It is effective under conditions of uncertainty and instability.

Activity-based Budget

Activity-based budgeting budgets costs for individual activities.

Target Budget

A target budget is a plan in which categories of major expenditures are matched to company goals. The emphasis is on formulating methods of project funding to move the company forward. There must be strict justification for large dollars and special project requests.

Continuous (Rolling) Budget

A continuous (rolling) budget is one that is revised on a regular (continuous) basis. Typically, a company extends such a budget for another month or quarter in accordance with new data as the current month or quarter ends. For example, if the budget is for 12 months, a budget for the next 12 months will be available continuously as each month ends. Note: Fixed budgets are criticized as being ineffective in a rapidly changing world. Companies report performance on a calendar basis, but floods, stock market crashes, strikes, and a competitor’s new product
announcement, happen continuously. In consequence, some leading companies have abandoned fixed budgets and changed to rolling forecasts to inspire and lead their companies to better performance. Rolling forecasts direct management’s attention towards the future, and ensure that planning is ongoing, as opposed to an annual exercise.

**Budgetary Process**

A sound budget process communicates organizational goals, allocates resources, provides feedback, and motivates employees. The budgetary process should be standardized by using budget manuals, budget forms, and formal procedures. Software, Program Evaluation and Review Technique (PERT), and Gantt facilitate the budgeting process and preparation. The timetable for the budget must be kept. If the budget is a “rush job,” unrealistic targets may be set.

The budget process used by a company should suit its needs, be consistent with its organizational structure, and take into account human resources. The budgetary process establishes goals and policies, formulates limits, enumerates resource needs, examines specific requirements, provides flexibility, incorporates assumptions, and considers constraints. The budgeting process should take into account a careful analysis of the current status of the company. The process takes longer as the complexity of the operations increase. A budget is based on past experience plus a change in light of the current environment.

The six steps in the budgeting process are:

1. Setting objectives
2. Analyzing available resources
3. Negotiating to estimate budget components
4. Coordinating and reviewing components
5. Obtaining final approval
6. Distributing the approved budget

A budget committee should review budget estimates from each segment, make recommendations, revise budgeted figures as needed, and approve or disapprove of the budget. The committee should be available for advice if a problem arises in gathering financial data. The committee can also reconcile diverse interests of budget preparers and users.

The success of the budgeting process requires the cooperation of all levels within the organization. For example, without top management or operating management support, the budget will fail. Those involved in budgeting must be properly trained and guided in the objectives, benefits, steps, and procedures. There should be adequate supervision.

The preparation of a comprehensive budget usually begins with the anticipated volume of sales or services, which is a crucial factor that determines the level of activity for a period. In other cases, factory capacity, the supply of labor, or the
availability of raw materials could be the limiting factor to sales. After sales are forecast, production costs and operating expenses can be estimated. The budgeting period varies with the type of business, but it should be long enough to include complete cycles of season, production, inventory turnover, and financial activities. Other considerations are product or service to be rendered and regulatory requirements.

The budget guidelines prepared by top management are passed down through successive levels in the company. Managers at each level may make additions and provide greater detail for subordinates. The managers at each level prepare the plans for items under their control. For example, Philip Morris formulates departmental budgets for each functional area.

The budgeting process will forewarn management of possible problems that may arise. By knowing the problems, solutions may be formulated. For example, at the valleys in cash flow, a shortage of cash may occur. By knowing this in advance, management may arrange for a short-term loan for the financing need rather than face a sudden financing crisis. In a similar vein, planning allows for a smooth manufacturing schedule to result in both lower production costs and lower inventory levels. It avoids a crisis situation requiring overtime or high transportation charges to receive supplies ordered on a rush basis. Without proper planning, cyclical product demand needs may arise, straining resources and capacity. Resources include material, labor, and storage.

**Bottom-up Versus Top-down**

A budget plans for future business actions. Managers prefer a participative bottom-up approach to an authoritative top-down approach. The bottom-up method begins at the bottom or operating (departmental) level based on the objectives of the segment. However, operating levels must satisfy the overall company goals. Each department prepares its own budget (such as estimates of component activities and product lines by department) before it is integrated into the master budget.

Managers are more motivated to achieve budgeted goals when they are involved in budget preparation. A broad level of participation usually leads to greater support for the budget and the entity as a whole, as well as greater understanding of what is to be accomplished. Advantages of a participative budget include greater accuracy of budget estimates. Managers with immediate operational responsibility for activities have a better understanding of what results can be achieved and at what costs. Also, managers cannot blame unrealistic goals as an excuse for not achieving budget expectations when they have helped to establish those goals. Despite the involvement of lower-level managers, top management still must participate in the budget process to ensure that the combined goals of the various departments are consistent with profitability objectives of the company.

The goals may include growth rates, manpower needs, minimum return on investment, and pricing. In effect, departmental budgets are used to determine the organizational budget. The budget is reviewed, adjusted if necessary, and approved
at each higher level. The bottom-up approach would forecast sales by product or other category, then by company sales, and then by market share. The bottom-up method may be used to increase the feeling of unit-level ownership in the budget. Disadvantages are the time-consuming process from participative input and the fact that operating units may neglect some company objectives. Bottom-up does not allow for control of the process, and the resulting budget is likely to be unbalanced with regard to the relationship of expenses to revenue.

Typical questions to answer when preparing a bottom-up budget are: What are the expected promotional and travel expenses for the coming period? What staff requirements will be needed? What are the expected raises for the coming year? What quantity of supplies will be needed?

This approach is particularly necessary when responsibility unit managers are expected to be very innovative. Unit managers know what must be achieved, where the opportunities are, what problem areas must be resolved, and where resources must be allocated.

In the top-down approach, a central corporate staff under the chief executive officer or president determines overall company objectives and strategies, enumerates resource constraints, considers competition, prepares the budget, and makes allocations. Management considers the competitive and economic environment. Top management knows the company’s objectives, strategies, resources, strengths, and weaknesses. Departmental objectives follow from the action plans.

Top-down is commonly used in long-range planning. A top-down approach is needed for a company having significant interdependence among operating units to enhance coordination. The top-down approach first would forecast sales based on an examination of the economy, then the company’s share of the market and the company’s sales, and then sales by products or other category. A top-down approach may be needed when business unit managers must be given specific performance objectives due to a crisis situation and when close coordination is required between business units. It is possible that the sum of the unit budgets would not meet corporate expectations. If unit managers develop budgets independently of other units, there are inconsistencies in the assumptions used by different units.

A disadvantage with this approach is that central staff may not have all the knowledge needed to prepare the budget within every segment of the organization. Managers at the operating levels are more knowledgeable and familiar with the segment’s operations. Managers will not support or commit to a budget they were not involved in preparing, which will cause a motivational problem. Further, the top-down approach stifles creativity. A budget needs input from affected managers, but top management knows the overall picture.

A combination of the bottom-up and top-down approaches may be appropriate in certain cases. Some large companies may integrate the methods. For example, Konica Imaging uses whichever method fits best. The company uses a blend. Direction is supplied from the top, and senior management develops action plans. Each department must then determine how it will actually implement the plan, specifically looking at the resources and expenditures required. This is
the quantification of the action plans into dollars. It is then reviewed to see if it achieves the desired results. If it does not, it will be kicked back until it is brought in line with the desired outcomes. The what, why, and when is specified from the top, and the how and who is specified from the bottom.

As an example of the budgeting process, Power Cord and Cable Corporation (PCCC) uses a comprehensive or master budget to summarize the objective of all its subunits such as Sales, Production, Marketing, Administrative, Purchasing and Finance. Like all organizations, PCCC uses a master budget as a blueprint for planned operations in a particular time period.

**Budget Coordination**

There should be one person responsible for centralized control over the budget who must work closely with general management and department heads. A budget is a quantitative plan of action that aids in coordination and implementation. The budget communicates objectives to all the departments within the company. The budget presents upper management with coordinated and summarized data as to the financial ramifications of plans and actions of various departments and units within the company.

Budgets usually are established for all departments and major segments in the company. The budget must be comprehensive, including all interrelated departments. The budget process should receive input from all departments so there is coordination within the firm. For example, operations will improve when marketing, purchasing, personnel, and finance departments cooperate.

Coordination involves obtaining and organizing the needed personnel, equipment, and materials to carry out the business. A budget aids in coordination between separate activity units to ensure that all parts of the company are in balance with each other and know how they fit in. It discloses weaknesses in the organizational structure. The budget communicates to staff what is expected of them. It allows for a consensus of ideas, strategies, and direction.

The interdependencies between departments and activities must be considered in a budget. For example, the sales manager depends on sufficient units produced in the production department. Production depends on how many units can be sold. Most budget components are affected by other components. For example, most components are impacted by expected sales volume and inventory levels, while purchases are based on expected production and raw material inventories.

A budget allows for directing and control. Directing means supervising the activities to ensure they are carried out in an effective and efficient manner within time and cost constraints. Controlling involves measuring the progress of resources and personnel to accomplish a desired objective. A comparison is made between actual results and budgeting estimates to identify problems needing attention.

In summation, the budget must consider the requirements of each department or function and the relationship that departments or functions have with other departments and functions. Activities and resources have to be coordinated.
Departmental Budgeting

All department managers within a company must accurately determine their future costs and must plan activities to accomplish corporate objectives. Departmental supervisors must have a significant input into budgeting costs and revenues because these people are directly involved with the activity and have the best knowledge of it. Managers must examine whether their budgetary assumptions and estimates are reasonable. Budget targets should match manager responsibilities. At the departmental level, the budget considers the expected work output and translates it into estimated future costs.

Budgets are needed for each department. The sales department must forecast future sales volume of each product or service as well as the selling price. It will also budget costs such as wages, promotion and entertainment, and travel. The production department must estimate future costs to produce the product or service and the cost per unit. The production manager may have to budget work during the manufacturing activity so the work flow continues smoothly. The purchasing department will budget units and dollar purchases. There may be a breakdown by supplier. There will be a cost budget for salaries, supplies, rent, and so on. The stores department will budget its costs for holding inventory. There may be a breakdown of products into categories. The finance department must estimate how much money will be received and where it will be spent to determine cash adequacy. An illustrative budget showing revenue and expense by product line appears in Exhibit 1.2.

Actual Costs Versus Budget Costs

A budget provides an early warning of impending problems. The effectiveness of a budget depends on how sound and accurate the estimates are. The planning must take all factors into account in a realistic way. The budget figures may be inaccurate because of such factors as economic problems, political unrest, competitive shifts in the industry, introduction of new products, and regulatory changes.

At the beginning of the period, the budget is a plan. At the end of the period, the budget is a control instrument to assist management in measuring its performance against the plan so as to improve future performance. Budgeted revenue and costs are compared to actual revenue and costs to determine variances. A determination has to be made whether the variances are controllable or uncontrollable. If controllable, the parties responsible must be identified. Action must be taken to correct any problems.

A comparison should be made between actual costs at actual activity to budgeted costs at actual activity. In this way, there is a common base of comparison. The percentage and dollar difference between the budget and actual figures should be shown. A typical performance report for a division appears in Exhibit 1.3.

Authorized variances in cost budgets allow for an increase in the initial budget for unfavorable variances. This increase may result from unexpected wage
### Exhibit 1.2

Statement of Revenue and Expense by Product for the Year Ended 20X2

<table>
<thead>
<tr>
<th>Description</th>
<th>All Products</th>
<th>Product Line</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>X Amount</td>
</tr>
<tr>
<td>Gross revenue</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: Sales returns and allowances</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net revenue</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: Variable cost of sales</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manufacturing contribution margin</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct distribution costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Variable costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Semi-direct distribution</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Variable costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contribution margin</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Continuing costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed overhead</td>
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</tr>
<tr>
<td>Other indirect costs</td>
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</tr>
<tr>
<td>Total</td>
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<tr>
<td>Income before taxes</td>
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<td></td>
</tr>
<tr>
<td>Less: Taxes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
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</tr>
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</table>
Exhibit 1.3

XYZ Company
Divisional Performance Evaluation
December 31, 20X2

<table>
<thead>
<tr>
<th>Division</th>
<th>Net Income</th>
<th>Over (Under)</th>
<th>Net Sales</th>
<th>Over (Under)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Actual</td>
<td>Expected</td>
<td>Plan</td>
<td>Actual</td>
</tr>
<tr>
<td>A</td>
<td>$ 2,000</td>
<td>$ 4,000</td>
<td>($2,000)</td>
<td>$1,000</td>
</tr>
<tr>
<td>B</td>
<td>3,000</td>
<td>5,000</td>
<td>(2,000)</td>
<td>700</td>
</tr>
<tr>
<td>C</td>
<td>5,000</td>
<td>6,000</td>
<td>(1,000)</td>
<td>600</td>
</tr>
<tr>
<td>Total</td>
<td>$10,000</td>
<td>$15,000</td>
<td>($5,000)</td>
<td>$2,300</td>
</tr>
</tbody>
</table>

Increases, prices of raw materials, and so on. Allowance is given for cost excesses that a manager can justify.

**Budget Revision**

A budget should be monitored regularly. A budget should be revised to make it accurate during the period because of error, feedback, new data, changing conditions (e.g., economic, political, corporate), or modification of the company’s plan. Human error is more likely when the budget is large and complex. A change in conditions typically will affect the sales forecast and resulting cost estimates. Revisions are more common in volatile industries. The budget revision applies to the remainder of the accounting period.

A company may “roll a budget,” which is continuous budgeting for an additional incremental period at the end of the reporting period. The new period is added to the remaining periods to form the new budget. Continuous budgets reinforce constant planning, consider past information, and take into account emerging conditions.

**Budget Weaknesses**

The signs of budget weaknesses must be spotted so that corrective action may be taken. Such signs include:

- Managerial goals are off target or unrealistic.
- There is management indecisiveness.
- The budget takes too long to prepare.
Budget preparers are unfamiliar with the operations being budgeted and do not seek such information. Budget preparers should visit the actual operations firsthand.

- Budget preparers do not keep current.
- The budget is prepared using different methods each year.
- There is a lack of raw information going into the budgeting process.
- There is a lack of communication between those involved in budgeting and operating personnel.
- The budget is formulated without input from those affected by it. This will likely result in budgeting errors. Further, budget preparers do not go into the operations field.
- Managers do not know how their budget allowances have been assigned or what the components of their charges are. If managers do not understand the information, they will not perform their functions properly.
- The budget document is excessively long, confusing, or filled with unnecessary information. There may be inadequate narrative data to explain the numbers.
- Managers are ignoring their budgets because they appear unusable and unrealistic.
- Managers feel they are not getting anything out of the budget process. Changes are made to the budget too frequently.
- Significant unfavorable variances are not investigated and corrected. These variances may also not be considered in deriving budgeted figures for next period. Further, a large variance between actual and budgeted figures, either positive or negative, that repeatedly occurs is an indicator of poor budgeting. Perhaps the budgeted figures were unrealistic. Another problem is that after variances are identified, it is too late to correct their causes. Further, variance reporting may be too infrequent.
- There is a mismatching of products or services.

Budgetary Control and Audit

As discussed previously, the budget is a major control device for revenue, costs, and operations. The purpose is to increase profitability and reduce costs, or to meet other corporate objectives as quickly as possible. Budgetary control may also be related to nonfinancial activities, such as the life cycle of the product or seasonality. An illustrative budget control report is shown in Exhibit 1.4.

A budget audit should be undertaken to determine the correctness of the budgeted figures. Was there a proper evaluation of costs? Were all costs included that should have been? What are the cost trends? Are budgeted figures too tight or too loose? Are budgeted figures properly supported by documentation? A budget audit appraises budgeting techniques, procedures, manager attitudes, and effectiveness. The major aspects of the budgeting process have to be examined.

Exhibit 1.5 depicts the control process in budgeting.
Exhibit 1.4

Budget Control Report

I. Budget Savings
   One-year Savings Amount:
   Two- to Five-Year Savings Amount:
   More Than Five-Year Savings Amount:
   Savings Description:

II. Budget impact
    Reduction in Current Year Budget
       Budget Account
       Budget Amount
       Budget Adjustment Not Needed

III. Budget Participants
    Management: Names: Job Description:
    Employees: Names: Job Description:

IV. Management Incentives:

V. Employee Awards

Prepared By:
Reviewed By:
Approved By:

Computer Applications

A computer should be used to make quick and accurate calculations, keep track of projects instantly, and make proper comparisons.

With the use of a spreadsheet program, budgeting can be an effective tool to evaluate “what-if” scenarios. This way the manager should be able to move toward finding the best course of action among various alternatives through simulation. If the manager does not like the result, he or she may alter the contemplated decision and planning set. Specialized software that is solely devoted to budget preparation and analysis also exists.

Motivation

Budgets can be used to affect employee attitudes and performance. Budgets should be participative, including participation by those to be affected by them. Further, lower-level employees are on the operating line every day so they are quite knowledgeable. Their input is needed. Budgets can be used to motivate because
participants will internalize the budget goals as their own since they participated in their development. Information should be interchanged among budget participants. An imposed budget will have a negative effect on motivation. Further, there is a correlation between task difficulty and loss of control to negative attitudes.

A budget is a motivational and challenging tool if it is tight but attainable. It has to be realistic. If the budget is too tight, it results in frustration because managers will give up and not try to achieve the unrealistic targets. If it is too loose, complacency will arise and workers may goof off.

The best way to set budget targets is with a probability of achievement by most managers 80 to 90 percent of the time. Performance above the target level should be supplemented with incentives including bonuses, promotion, and additional responsibility.

**Advantages and Disadvantages of Budgets**

Budgeting involves cost and time to prepare. The benefits of budgeting must outweigh the drawbacks. A budget can be advantageous because it:

- Links objectives and resources.
- Communicates to managers what is expected of them. Any problems in communication and working relationships are identified. Resources and requirements are identified.
The What and Why of Budgeting

- Establishes guidelines in the form of a road map to proceed in the right direction.
- Improves managerial decision making because emphasis is on future events and associated opportunities.
- Encourages delegation of responsibility and enables managers to focus more on the specifics of their plans and how realistic the plans are, and how such plans may be effectively achieved.
- Provides an accurate analytical technique.
- Provides better management of subordinates. For example, a manager can use the budget to encourage salespeople to consider their clientele in long-term strategic terms.
- Fosters careful study before making decisions.
- Helps management become aware of the problems faced by lower levels within the organization. It promotes labor relations.
- Allows for thinking how to make operations and resources more productive, efficient, competitive, and profitable. It leads to cost reduction.
- Allows management to monitor, control, and direct activities within the company. Performance standards act as incentives to perform more effectively.
- Points out deviations between budget and actual, resulting in warning signals for changes or alterations.
- Helps identify, on a timely basis, weaknesses in the organizational structure. There is early notice of dangers or departures from forecasts. The formulation and administration of budgets pinpoints communication weaknesses, assigns responsibility, and improves working relationships.
- Provides management with foresight into potential crisis situations so alternative plans may be instituted.
- Provides early signals of upcoming threats and opportunities.
- Aids coordination between departments to attain efficiency and productivity. There is an interlocking within the business organization. For example, the production department will manufacture based on the sales department’s anticipated sales volume. The purchasing department will buy raw materials based on the production department’s expected production volume. The personnel department will hire or lay off workers based on anticipated production levels. Executives are forced to consider relationships among individual operations and the company as a whole.
- Provides a motivational device setting a standard for employees to achieve.
- Provides measures of self-evaluation.
- Management can make distasteful decisions and blame it on the budget.

A budget can be disadvantageous because:

- A budget promotes gamesmanship in that those managers who significantly inflate requests, knowing they will be reduced, are in effect rewarded by getting what they probably really wanted.
A budget may reward managers who set modest goals and penalize those who set ambitious goals that are missed.

- There is judgment and subjectivity in the budgeting process.
- Managers may consider that budgets redirect their flexibility to adjust to changing conditions.
- A budget does not consider quality and customer service.

**Conclusion**

A budget should be based on norms and standards. The budget should be coordinated, integrated, organized, systematic, clear, and comprehensive to accomplish optimal results. The budget preparation, review, and evaluation process must be facilitated. An orderly budgeting process will result in less cost, less man-hours, and minimization of conflict and turmoil. It will require less revision at a later date. The budget process must consider input-output relationships. The budget aids in anticipating problems before they become critical. Short-term budgets should be used for businesses subject to rapid change. A budget is a tool for planning and for “what-if” analysis. It aids in identifying the best course of action.

As it is in the computer world—garbage in, garbage out—so it is with budgeting. If forecasts are inaccurate so will be the projections, resulting in bad management decisions to the detriment of the firm. A manager must be cautious when analyzing past experience. Unforeseen circumstances such as economic downturns and future innovations have direct inputs on current operations. A manager deviating from a budget target must explain why and, of course, is on the defensive. Without proper justification for missing targets, the manager may be dismissed.

The failure to budget may result in conflicting and contradictory plans as well as in wasting corporate resources. Budget slack should be avoided or minimized. Budget slack is the underestimation of revenues and the overestimation of expenses. Budgets should be revised as circumstances materially change. A manager who has responsibility to meet a budget should also have the authorization to use corporate resources to accomplish that budget. Priorities should be established for the allocation of scarce resources. Budgets may include supplementary information such as break-even analysis by department, by product, and for overall operations.

It is important to avoid the situation in which a manager feels he or she must spend the entire budget or else lose funding in the next period. Managers should not be motivated to spend the entire budget. Rather, cost savings should be realized, and those responsible should be recognized, such as through cash bonuses or nonmonetary awards (e.g., trophy, medals). Budget savers should be protected in the funding for future budgets.

Budgets should not be arbitrarily cut across the board. Doing so may result in disastrous consequences in certain programs. If budget reductions are necessary, determine exactly where and by how much.