Online Course Manual

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Module 6

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Module 6 Summary

I. **Budgets** are prepared by all types of organizations in order to (1) *plan* future operations and (2) to *control* operations by establishing standards that can be used to evaluate performance.

> *Instructor's Lecture Notes*: Recall the management functions listed in Module 1: planning, directing, controlling, improving and deciding. Obviously, budgets, since they represent planning and control devices, are an integral part of the management process.

A. Budgeting formalizes the planning process, and forces managers to assess the firm's future position realistically (i.e., to "think ahead"). Potential problems are identified in advance of their occurrence so that they can be avoided, if possible. Failure to do this results in the undesirable practice of "management by crisis," in which managers spend all their time dealing with problems ("putting out fires") that could have been avoided.

1. Budgets are planning documents that may contain both financial and nonfinancial data. Their primary objective relates to the *forecasting of future events*. This means that the data they contain are based upon estimates and projections. Despite the error that is inherent in estimation, the goal is to provide accurate, meaningful data to the users of the information the budgets contain.

2. Budgets may be prepared in any format and may contain any information that the company and its management finds useful. The budget should contain *enough* information to meet managers' needs but distracting, irrelevant information should be eliminated.

3. Budgets are communication and coordination aids that force managers to put their thoughts on paper and share them with others in the organization. The budgeting process thus produces a synthesis of individual perspectives and viewpoints, which results in (1) a more realistic and accurate budget and (2) a uncontrollable perspective regarding the organization's objectives and each manager's role in achieving them. This encourages teamwork and fosters a coordination of efforts between departments and managers that might not exist otherwise.

B. Once the budget is establish, budgeted amounts represent *benchmarks* against which future performance may be evaluated in order to control business operations. The following module details the way in which budget ***standards*** should be established and ***variances*** from them may be analyzed.

1. ***Responsibility accounting*** refers to the use of budget standards to evaluate ***responsibility centers*** (individual managers, departments or divisions).

2. The major goal in responsibility accounting is to hold managers responsible for only those factors the manager can control. Performance reports must be prepared in accordance with this principle.

3. In the modern JIT production environment, operating performance must be monitored closely making it necessary to provide managers with continuously updated budget information.

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II. Preparation of the Budget. In order to prepare a budget, the ***budget period*** must be established and data must be gathered.

A. The ***budget period*** (the period of time the budget will cover) should be long enough to give timely warning of future problems, but short enough so that reasonably good estimates may be made.

1. *Period budgets* are detailed operating budgets for a specific period of time, usually one year or less. *Long-term plans* are more general in nature since the detailed revenue and cost figures that will occur so far in the future cannot be estimated with any degree of confidence.

2. ***Continuous budgets*** (also called *perpetual budgets*, or *rolling budgets*) are cast for a period of time (say, 12 months), and then are updated monthly (or quarterly). The idea is to add a new month (or quarter) as one is ended, so that the budget always covers the coming 12 month period.

B. Budgets may be "imposed" upon the organization by top management, or they may be developed from the "bottom-up" by involving workers and mid-managers in their construction. "Bottom-up" budgeting is called ***participative budgeting***, and the result is a *self-imposed budget*.

1. The success of the budgeting process depends upon many "people" factors and it is important that all persons at all levels in the organization be involved in the budgeting process. *Participative budgeting* is an important component of effective budgeting. Standards are perceived as fair since the persons who will be evaluated by them help establish them ("self-imposed" standards); lower-level employees feel valued and important, improving morale; and the budgets may be more realistic since they are established by the people most closely in touch with day-to-day operations. When done well, the budgeting process reduces ***goal conflicts*** (differences between the goals of individual managers and the overall organization), motivates employees to perform well, and provides management with a reliable and useful strategic planning tool.

2. A budget committee must be established that can work successfully between top management and lower-level managers. The committee is responsible for coordinating the process of communicating the long-range goals established by top management to the parties who must establish short-term plans, and passing feedback from lower-level management back to top management. Clear and complete communication must occur between all the parties involved in the budgeting process.

3. Top management must actively support the participative budgeting process. Employees must feel that top management views budgeting as vitally important, and that budget standards will be used as a problem identification tool and not an unfair punishment mechanism.

4. Good budgeting housekeeping principles must be followed in exercising budgetary control over the organization. This requires that (1) a realistic approach must be taken by all participants when establishing the budget (it is tempting for managers to "***pad***" their budgets by building in "***slack***" to protect themselves), (2) deadlines must be met, and (3) since budget standards are based upon what are sometimes very uncertain estimates, flexibility must be applied when the budget is used to evaluate performance.

5. Budget follow-up procedures should be carried out to identify weaknesses in the budgeting process and to correct errors in the estimates that make up the budget once they are identified.

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C. ***Zero-Based Budgeting*** requires managers to "start from zero" when preparing budgets, essentially justifying all expenditures on the manager's budget. This is in contrast to an incremental budgeting approach, where the manager begins with last period's budget and adds to or subtracts from the amounts on it.

1. Zero-based budgeting provides tighter control over expenditures than incremental budgeting does, but also results in much more administrative effort and cost.

2. When it is used, it is often applied intermittently to reduce cost. For example, the company may apply zero-based budgeting every fifth year, utilizing an incremental approach in the other four years.

D. The budget may be a ***static budget*** (a budget established for a single expected level of activity) or a ***flexible budget*** (a budget that can be easily restated for any level of activity). Flexible budgets make performance assessment possible for any activity level attained during the period. Static budgets are only useful in assessing performance if the budgeted activity level is actually attained. Static budgets are generally not used for performance evaluations because they distort budget variances. For example, if a strike shuts down the plant for 2 weeks and only half the units that were scheduled to be produced are actually completed, should we be surprised to find that the actual production costs are all well below the amounts listed on the static budget that was prepared for twice as much production?

III. The Master Budget.

A. The ***master budget*** is a set of schedules and other component budgets that culminate in a forecasted income statement for the budget period and a forecasted balance sheet as it will appear at the end of the budget period.

B. The master budget is composed of a ***sales budget***, ***production budget***, ***materials purchases budget*** with a ***schedule of cash payments for materials, direct labor budget***, ***overhead cost budget***, ***selling and administrative expense budget***, ***cash budget***, ***capital expenditures budget***, the ***forecasted income statement*** and the ***forecasted balance sheet***.

C. The processes involved in setting up the master budget is not illustrated in this manual, and you are not responsible for being able to prepare all the schedules and sub-budgets that make up the master budget. You should, though, have a general understanding of the process. Please refer to your text, which illustrates the development of the master budget in detail.

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