Budgeting and the Planning and Control Process

Learning Objectives

By the end of this chapter, you should be able to:

- Describe how the budget is a component of the planning and control process.
- Explain the three components of planning—mission, goals, and objectives.
- Describe how performance reports relate to budgets.
- List the advantages of budgeting.
- Describe how budgeting is related to strategic planning.
- Describe the budget administration process.

INTRODUCTION

Have you ever tried to use a documented personal budget? If you have, how long did you use it? Many people answer yes to the first question, but the answer to the second question is typically: not very long. When I ask why, the answer is that it was not worth the trouble.

How many business and nonprofit organizations use budgets? The answer is an incredible number do. Why? The answer is that the cost of budgeting is worth the resulting benefits.

This chapter presents an overview of budgeting in the planning and control process. Many of the concepts explained in this chapter will be used in subsequent parts of the course.
PLANNING

Planning is important to an organization for several reasons. It provides a framework for making decisions by establishing goals, objectives, and strategies. It is oriented toward the future and involves an awareness of how today’s decisions will affect tomorrow’s opportunities. Planning is essential for achieving both short- and long-run organizational goals, and successful managers are continuously planning.

Goals

Planning starts, of course, with setting goals and objectives. As you know, goals are desired qualitative and quantitative results. They are broad in nature and few in number, and goals provide a basic direction for the organization's management. They should be documented in a clear, concise fashion so that they provide specific direction for all levels of management. For example, the goal to achieve zero defects is easily remembered and easily understood.

Goals also provide standards for measuring managerial performance. A quantitative one, such as achieving a return on sales of 8 percent, can be measured very precisely. Conversely, a qualitative goal, such as making quality a priority in daily operations, is less precise; and it is more difficult to measure progress toward achieving it.

An organization should be careful not to set too many goals. Having fifty, for example, would be overwhelming. Managers would not remember all of them and would end up focusing on relatively few. Conversely, having only one goal, such as being profitable, is not enough to guide managers.

Goals typically are directed at one or more of the following areas:

- Profitability
- Market position
- Quality
- Size
- Cost leadership
- Product differentiation

Large organizations typically develop a hierarchy of goals. Top management usually sets corporate ones. Next, goals are set at successively lower levels in the organization. These subgoals help lower-level managers direct their efforts toward accomplishing corporate goals. One qualifier to the above: in many organizations managers at lower levels participate in the process of setting corporate goals. Examples of this hierarchy of goals concept are illustrated in Exhibit 1-1.

Objectives

We have emphasized here that goals provide the basic direction for planning. As you no doubt also know, objectives provide more specific direction
for managers in their day-to-day operations. For example, a goal may be to attain a specific percentage of market share. Objectives provide the steps toward this goal. These steps might include sales goals by territory and by product divisions.

Objectives should be:

- Results-oriented rather than activity-oriented. For example, increase sales in the eastern region by 5 percent.
- Stated in measurable terms such as dollars or percent increase so that a performance evaluation is feasible.
- Stated clearly so that confusion is avoided.
- Time-specific to provide deadlines for accomplishment.
- Attainable in management's opinion.

Many corporations have developed detailed formal systems to force managers to plan since managers have an aversion to doing it. The budget is, of course, a component of this system.
The budget can be defined as a financial plan showing how the organization will acquire resources and use them in operations during a specified time period, usually one year. A budget takes the form of a pro forma set of financial statements and supporting schedules. Pro forma means that figures are expected amounts as opposed to actual historical amounts. The budget is typically compiled on a monthly basis. Budgets are explained by detailed descriptions of what managers expect to do in the short run.

Control Systems
Results-oriented objectives are the basis for controlling operations. Controlling also involves monitoring the implementation of plans through performance reviews. They are used to compare actual results with objectives. The frequency depends upon the time-specific nature of the objectives. For example, some objectives involve daily operations, and obviously daily performance reporting is appropriate. To illustrate, an objective might be to reduce spoilage to less than 1 percent per day for an ice cream manufacturer. Daily, or even hourly, reporting may be used for feedback in this case. The nature of the factors under management's control will also influence the frequency.

Weekly, monthly, and quarterly performance reports measure how successful the organization has been in achieving its financial goals and objectives. Variances from budget are typically presented in a performance report so that unexpected results can be quickly identified. Performance reports have to be timely so that the manager responsible for an activity becomes aware of variances as soon as possible. They also have to be attention-directing in nature, highlighting the most significant variances. The manager responsible for a particular variance should be empowered to take corrective action with regard to a variable under the firm's control.

ADVANTAGES OF BUDGETING
Having a budgeting system does not guarantee that the organization's planning efforts will be improved. In some organizations, the budget is used as a planning process, but there is little emphasis on using it to control operations. Budgeting is a cost-benefit proposition; the system has to be designed to be cost-effective.

The advantages of budgeting must be emphasized periodically so that managers at various levels take the process seriously and maximum benefit is attained. As mentioned earlier, there sometimes is an aversion to planning. By emphasizing the advantages of planning and budgeting on a continuous basis, this aversion should be overcome.

Forced Planning
The most important advantage of budgeting is, of course, that it forces managers to plan ahead. As a result of the corporate restructuring in the 1980s
and early 1990s, many managers have had to make, and are still making, many changes in their day-to-day operations. Simply stated, managers are very busy. Today's world is changing so fast that managers are not simply dealing with routine situations on a day-to-day basis. Instead, they must deal with complex problems without easy or known solutions. Working within the framework of a plan facilitates tough decision-making responsibilities.

A formalized budgeting system forces managers at all levels to plan. The critical review of their proposed budget at higher managerial levels raises questions about the way things are being done at lower levels. Managers must step back from daily operations and take a wider view of what's really happening in their areas of responsibility.

Coordination of Activities

As you know, organizations are composed of many segments covering many functions and programs. During the budgeting process the plans and related financial budgets of the various segments are brought together in one place. Typically, a budget committee will review these plans and try to integrate them into a total plan to achieve the organization's goals. During this process, many questions are asked of the various managers in the organization. As a result, there is communication up the organization from subordinates to superiors. There is also communication between managers across section and department lines. For example, if marketing plans to sell one million units, production must have plans and a budget to produce these units. In turn, purchasing must have plans to acquire the necessary raw materials to meet production schedules. It is inevitable that the plans of the various departments will change during this process. This revision process forces coordinated and continuous planning at the various levels in the organization.

Performance Evaluation

Performance evaluation is not an easy task. Obviously, managers desire a fair evaluation of their performance. They want to know what is expected of them in advance.

When investors evaluate a company's performance, a common technique is to compare the current with historical results. While this is a useful technique for an investor, for evaluating managers' performance the firm has a better option. This is to use the budget as a benchmark. Of course a manager's performance can be fairly evaluated only by identifying the controllable and uncontrollable factors that cause a significant variance between planned and actual results. If a variance is caused by an uncontrollable factor, we can ask whether it was predictable. Perhaps it wasn't and nothing could have been done. Alternatively, the manager could have been prepared to take other actions. While the results cannot be changed, competencies of managers can be assessed and lessons are learned.

For example, a division manager may have earned a profit of $600,000 last year. A historical benchmark approach for this division manager would
be to expect profits to increase by the same proportion in the coming year. Perhaps management might simply say we expect profits to increase by 10 percent to $660,000. The problem with using this approach is that no attempt is being made to adjust for changes due to uncontrollable and controllable factors. Perhaps an investment was made in new technology toward the end of last year that should result in substantial efficiencies. This factor would cause us to expect a more substantial increase in profits. Using a budgeted income statement as a benchmark forces the divisional manager to factor in all the variables that are expected to change. A stringent headquarters' review of the division manager's plans and analysis can result in agreement on a realistic target for the next year. As a result, planning is integrated with performance evaluation.

Control Environment

Successful organizations create a control environment. They have an effective set of internal controls to assure compliance with management's policies and procedures. Controls must assure compliance by employees at all levels. Managers must understand and follow the limits on their authority to expend the organization's resources.

Monthly budgetary control reports on spending document the manager's actions in using the authority granted. Of course, the budgetary control system should allow for changes during the budget period. These authorized changes should be documented as part of the management control system.

Resource Allocation

During the budget planning phase many resource allocation decisions are made. A good example is capital expenditures. The various segments of an organization will request a budgeted dollar amount for these expenditures. Invariably, the total amount requested exceeds the organization's ability to finance that total. Consequently, a capital rationing process is used. Typically, the organization will use either the internal rate of return or net present value method of evaluating the competing proposals for capital expenditures. Both of these methods are described in Chapter 4. These methods enable management to look at how the competing requests will further the organization's capability to achieve its strategic plan.

Another example involves a nonprofit organization. It may have three or four different programs that it is pursuing. During the budget planning phase, the board of directors will have to decide whether resources should be diverted from one program to another. For example, an environmental organization has programs oriented toward improving water quality, improving air quality, and preserving the forests. The basic question of resource allocation facing the directors each year is what proportion of its resources to allocate to each of the three programs. After several years of giving priority to improving water quality, the board may decide that it is time to redirect resources toward improving air quality. This decision is, of course, documented in the budget.
Motivation

Budgets can be used by management to motivate managers and employees. If managers participate in the planning process and budget preparation, they are likely to develop more of a commitment to achieving the budget's objectives. In the process they also realize more fully that their piece of the budget is important in coordinating the overall plan. If an organization can develop a fair budget review process (and a fair performance evaluation process), managers will be motivated to achieve desired results. Conversely, if these processes are not perceived as fair, the budgetary system will have a negative effect on motivation. Unfortunately this is a common occurrence.

In many organizations promotions, raises, and bonuses are affected by managers' performance in achieving budgetary targets. In many larger firms, for example, division managers can earn a bonus by achieving the budgeted profit for the division. Unfortunately, there are many pitfalls in using budgets as a motivator. For example, a division manager may resort to techniques such as speeding up sales order processing at the end of the budget period to increase sales and earn a bonus.

BUDGETING AND STRATEGIC PLANNING

An organization's budgeting system is goal oriented. In many firms, the budget, designed to attain short-run goals, is prepared in conjunction with a five-year financial plan designed to achieve long-run goals. It is important to understand how an effective budgeting system fits into a firm's strategic and long-run planning process. While some firms don't have a very formalized strategic long-run planning process, at a minimum, top management has a basic strategy.

Strategic Planning

Strategies are possible courses of action aimed at achieving certain goals. They are the product of formal strategic thinking in the organization.

Strategic planning basically involves analyzing the attractiveness of an industry to customers and the firm's position in that industry versus its competitors. This process seeks to understand how alternative strategies available to the firm can possibly affect an industry's attractiveness and the firm's competitive position. As a result, resources are sometimes shifted from one division to another. In addition, larger firms have many business divisions, and they must consider the industry's attractiveness for each.

Strategic planning is involved with short-, intermediate-, and long-range strategies. Naturally it integrates short- and long-range plans.

Obviously, strategic planning involves creative thinking and a speculative mindset. Often analytical tools are also used, such as empirical studies of markets and trend analysis. The mindset in strategic planning is usually somewhat defensive in most firms, but it is offensive in some. The basic planning horizon is long-term with a view of the firm's position in the industry at the end of a planning horizon. Strategic planning involves a
general systems orientation with many different information sources providing a basis for the analysis. Strategic planners look at the big picture of how the industry and the world are changing. Analyzing the business, legal, and social environment is a very important component of strategic planning.

Mission Statement

An organization's mission statement specifies the basic purpose. For example, a nonprofit organization's mission might be to eradicate domestic violence in the county. A corporation's might be to produce the highest quality product and be the industry leader.

The mission statement should be clearly understood by all members of the organization and important publics, such as customers, creditors, and government.

Since the mission statement specifies the basic purpose of the organization, it is necessarily a first step in strategic planning. The mission statement for a firm is a general, enduring statement of the company's intent. The corporate mission statement expresses the outlook and orientation, rather than detailed, quantified targets or goals. It should contain only a few specific directives or concepts, which are stated in broad terms. A complex mission statement will not be understood throughout the organization and will not guide the thinking of management.

The mission statement should be designed to achieve potential benefits, such as:

- Providing a clear image of what the organization wants to achieve.
- Providing a basis for motivating people and resource allocation.
- Achieving a unanimity of purpose.
- Serving as an organizing force.
- Establishing an identity that will attract people who will want to work toward achieving the organization's mission.

All of these potential benefits should be kept in mind when establishing a mission statement. Some will be more influential than others, depending upon the organization. For example, the idea of establishing an identity to attract people who will want to accomplish the mission is very important to nonprofit organizations that have a cause. Obviously, if the cause is to stop domestic violence, having managers emotionally committed to the cause is critical.

The mission statement should help management look at where the organization is headed and guide it in selecting goals and strategies. As the organization grows, the mission statement may change or be refined. For example, the 1980s witnessed an increased emphasis in some mission statements on quality as a response to the United States' declining position in world manufacturing.

A corporation's mission statement usually contains several of the following issues:
• A basic product or service offered
• Primary market segments served
• Quality
• Service to customers
• Profitability
• Growth and survival
• Technologies created or employed
• Social responsibility

Competitive Forces

In the strategy formulation process, the firm assesses industry structure and competitive position in the industry with an eye toward achieving competitive advantage. Strategic planners try to understand the competitive forces that will influence their ability to gain a sustainable competitive advantage in the industry or industries they compete in.

Strategic planning literature contains many systematic frameworks for strategy formulation. There are recognizable similarities in many of these frameworks. The competitive strategy framework developed by Michael E. Porter seems to have had a significant impact in the 1980s and 1990s thus far. Porter (1980, ch. 1) employs a framework for first assessing industries and the competitors, and then formulating the firm's overall competitive strategy. His framework employs the analysis of five competitive forces that drive industry structure. These, in turn, dictate the long-run rates of return a firm can expect to realize in a particular industry. The five basic competitive forces are as follows:

1. The threat of new entrants
2. The threat of substitute products being introduced
3. The bargaining power of buyers
4. The bargaining power of suppliers
5. The rivalry among current competitors

Porter recognizes that the relative importance of these five forces differs by industry and changes over time. His framework also recognizes that current competitors determine only part of the competitive situation; potential entrants, customers, suppliers, substitute products, and new technologies also affect competitive structure. In addition, fundamental variables affect all organizations to some degree; economic, technological, cultural, social, political, and legal changes do affect strategic planning.

After evaluating industry attractiveness and the firm's competitive position within an industry, the firm must seek an opportunity for a competitive advantage. Competitive advantage (Porter, 1980, p. 3) is defined as the "value a firm is able to create for its buyers that exceeds the firm's cost of creating it. Value is what buyers are going to pay, and superior value stems from offering lower prices than competitors for equivalent benefits or providing unique benefits that more than offset a higher price." Porter believes that a firm must seek one of these two basic sources of competitive
advantage. He provides a value chain model for identifying whether the firm's opportunity for competitive advantage best lies in cost leadership or differentiation. Value-chain analysis is oriented toward a specific firm within an industry.

Planning Assumptions

As we stated earlier, strategic planning is ongoing in organizations. It involves assessment of the general environment, economic environment, and industry environment. The insights gained from the strategic planning process will have an impact on the planning assumptions used by the firm in its budgeting process. For budgeting purposes there has to be planning assumptions about long-range factors and short-range factors. One advantage of budgeting is coordination of the segments within the organization. Early in the budgeting process, planning assumptions are agreed upon and used as the basis for short-run planning and budgeting. This process facilitates the coordination of plans by various departments.

Goals and Strategies

Firms adopt strategies that provide a basic direction for goal setting. Some basic strategies will affect goal setting for a number of years. Examples of such strategies are as follows:

1. Concentrating on a single core business
2. Product development and innovation
3. Horizontal integration by acquiring competitors
4. Vertical integration by acquiring firms or initiating operations in different stages of the value chain
5. Conglomerate diversification by expanding into new unrelated businesses
6. Market development by marketing current products in related or new marketing areas
7. Joint venturing to share risks with other organizations in the quest for new opportunities
8. Divestiture by selling or discontinuing unprofitable businesses
9. Right-sizing by restructuring the firm's organization and operating procedures to a scale that is compatible with the current economic environment
10. Concentric diversification by entering new businesses related to the firm's current core areas of expertise

These strategies will affect both long-range and short-run planning. Exhibit 1-2 portrays the linkage between strategic planning and budgeting. As you know, strategic planning impacts long- and short-run planning. And these in turn affect the short-run budget process and the long-range financial plan. The exhibit's arrows point both ways to show that this is an interactive process. For example, the long-range plan cannot be
finalized until a satisfactory long-range financial plan is prepared. Typically, there is interaction because the long-range financial plan does not meet management's expectations. Management's response is to revise the long-range plan until some satisfactory financial planning result is achieved. Similarly, the short-run budgeting process affects short-run planning. Management has short-range financial goals, so often the initial short-run budget is not satisfactory, and short-run plans are revised as well.

We also see an arrow linking the short-run budget process with the long-range financial planning process. The short-run budget is the first year of this long-range plan, and naturally the underlying assumptions are related.

THE BUDGET ADMINISTRATION PROCESS

A variety of approaches can be used to administer the budget. They vary in the way top management controls the budget process. Most large organizations use some type of budget committee format. Another important ingredient is a budget manual, which describes policies and procedures and the all-important timetable for completion.

Budget Committee

Most large organizations appoint a budget committee. The advantage of having a budget committee is that members can be selected from the various functional areas of the organization. Since a basic purpose of the committee is to coordinate activities throughout the organization, members of the committee must have expertise in the various functional areas. These areas should include marketing, production, personnel, finance, and accounting.

The committee is chaired by the budget director, who has ultimate responsibility for formulating the budget. Exhibit 1-3 lists responsibilities that might be assumed by the budget director. The budget director's
position in the organization and the responsibilities assigned will affect the perceived importance of the budget by organization members. In some organizations the budget director has significant strategic authority.

Degree of Participation

There is an old saying, "People support what they help create." We have seen this idea applied to the budgeting process. A high degree of participation is often called the "bottom-up approach." The budgeting process is initiated at the bottom of the organization, and budgets are transferred up the organization from one level to another for review and modification. At each level, the manager discusses the plans with subordinates to understand their thinking. Thus, operating managers with detailed knowledge of the environment, competitive forces, and the marketplace are incorporated into the plans at lower levels. This approach empowers employees at lower levels to set targets and be innovative.

The bottom-up approach is compatible with the total quality management movement of the 1980s and 1990s. Managers at lower levels are empowered to assess performance and identify opportunities for continuous improvement. Lower-level managers better understand business processes, subprocesses, and activities. They are also more likely to be attuned to the needs of customers. This approach also allows for quick response to changes in competitive forces.

Exhibit 1-3
Examples of Responsibilities of the Budget Director

1. Organize the budget process.
2. Coordinate planning and budgeting.
3. Provide technical supervision of the budget.
4. Design forms, schedules, and reports to be used.
5. Develop and implement a benchmarking program.
6. Implement an activity-based budgeting program.
7. Recommend new control procedures.
8. Review budget requests for compatibility with total quality management philosophy.
9. Promote a continuous improvement philosophy.
10. Revise budgets when necessary.
Exhibit 1-4 portrays the two basic approaches to budgeting. At the authoritarian extreme we have the "top-down" approach. It allows the managers at the top of the organization to use their comprehensive understanding of the environment and the organization as a basis for preparing the budget. Top management sets targets for the various functional areas based upon its knowledge of the company's strategies, goals, and resources. Strict application of this approach involves no negotiation with managers at lower levels.

A variation that lies somewhere between the two extremes is the case where the top-down approach is modified to allow for negotiation with managers at middle levels in the organization.

Which approach is best? The bottom-up approach allows the budget to be influenced by managers who are closer to the customers. Thus customer needs can be recognized and prioritized more effectively. The main disadvantage of this approach is that it is very time consuming and thus a more costly budgeting practice. And in some types of businesses lower-level managers do not have the desire or capability to contribute to the budgeting process.

The top-down approach has the major advantage of simplicity and consistency. It often works best in smaller organizations where the owner-manager really knows the business. It is also often used when a firm is in a financial crisis and cannot afford the cost of bottom-up budgeting. However, there is a risk of incompleteness due to the lack of information about operational details. Also, managers may be dissatisfied with the budget and may not support achieving it.

Exhibit 1-5 illustrates the cycle-up, cycle-down process usually associated with the bottom-up approach. Initially the budgets are passed up from level 1 through 5 for review until they reach the budget committee.

The budget committee is responsible for coordinating the budget requests of the various sections of the organization. Inevitably, the pieces will not fit together. Consequently, the committee will suggest revisions to the budget requests and cycle them down to some middle level of the organization. This may be to the third or fourth level. A cycle-up, cycle-down process will continue until agreement is reached on a final master budget for the organization.
Many firms have developed sophisticated formal planning systems because there are proven benefits to planning. A critical component of these systems is the budget. Performance reporting based upon the budget is an essential element of the control process.

Budgeting offers many advantages, such as forcing planning, coordinating activities, motivating staff, and enhancing management control. These benefits are indeed available to all firms to varying degrees. (Ask yourself, “Is my organization getting these benefits from the budgeting system?”)

The budgeting system should be designed to be cost-effective, given the mission, strategies, and goals of the organization. Also, the budget administration process should be compatible with an organization's characteristics.
1. A budget takes the form of a pro forma set of financial statements and supporting schedules which are explained by:
   (a) detailed plans of what managers want to do.
   (b) the mission statement.
   (c) goals.
   (d) profitability.

2. Objectives should be:
   (a) activity oriented.
   (b) results oriented, measurable, and time specific.
   (c) in a hierarchy of goals.
   (d) quality oriented.

3. The frequency of performance reporting depends upon:
   (a) detailed plans of what managers want to do.
   (b) the mission statement.
   (c) goals.
   (d) the time-specific nature of the objectives.

4. Budgeted financial results are superior to historical financial results as a basis for performance evaluation because:
   (a) they adjust for expected changes outside the organization.
   (b) they adjust for changes in factors under the control of management.
   (c) they reflect targets that have been more recently set.
   (d) all of the above.
5. A pitfall in using budgets as a motivator is:
   (a) relying on a bottom-up approach too much.
   (b) having a budget review and performance evaluation process that is not viewed as being fair.
   (c) relying too much on capital rationing techniques.
   (d) ignoring the need for quality.

6. All except which of the following are characteristics of the mission statement?
   (a) It specifies the basic purpose of the organization.
   (b) It is a general enduring statement of the organization's intent.
   (c) It expresses the organization's outlook and orientation.
   (d) It expresses quantified targets and goals.

7. The two basic types of competitive advantage according to the Porter model are:
   (a) cost leadership and product differentiation.
   (b) bargaining power of buyers and of sellers.
   (c) quality and service to customers.
   (d) quality and the value chain.

8. To facilitate coordination of planning and budgeting, it is essential early in the process to agree upon:
   (a) a budget committee.
   (b) planning assumptions.
   (c) the value chain.
   (d) competitive forces.

9. A firm that is committed to total quality management and continuous improvement would generally want to:
   (a) have a strong budget committee.
   (b) use a bottom-up approach to budgeting.
   (c) use a top-down approach to budgeting.
   (d) use an authoritarian approach to budgeting.

10. Which of the following is not a characteristic of top-down budgeting?
    (a) Authoritarian management style
    (b) Imposes top management's views of industry
    (c) Advantages of consistency and simplicity
    (d) Advantages of completeness and achieving consensus support