

Chapter 9

Budgeting systems

Strategic planning and budgeting systems

- ◆ A budget
 - ▶ A detailed plan summarising the financial consequences of an organisation's operating activities
 - ▶ A financial model that summarises future operation
 - ▶ A critical step in planning any activity

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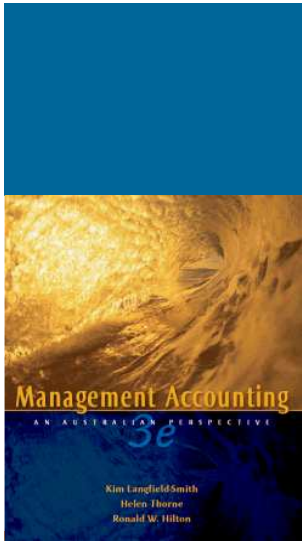
Strategic planning and budgeting systems

- ◆ Strategic planning is long term planning usually undertaken by senior managers
 - ▲ Decisions about the type of businesses and markets that the organisation operates in, and how those businesses and activities will be financed
 - ▲ Decisions about corporate strategy

Management Accounting

AN AUSTRALIAN PERSPECTIVE

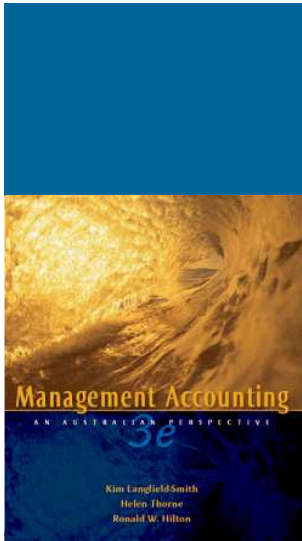
Kim Langfield-Smith
Helen Thorne
Ronald W. Hilton



Purposes of budgeting

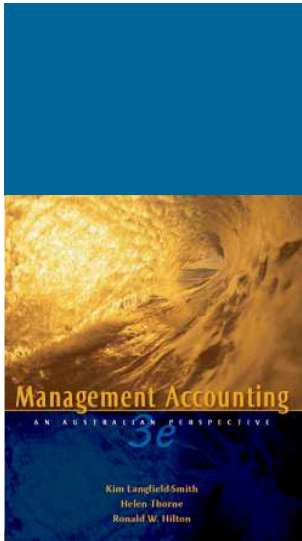
- ◆ Planning
 - ▲ To quantify a plan of action
- ◆ Facilitating communication and coordination
 - ▲ Provides a formal mechanism to enable communication and coordination
- ◆ Allocating resources
 - ▲ Provides a forum for evaluating alternative use of resources among competing users

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Purposes of budgeting

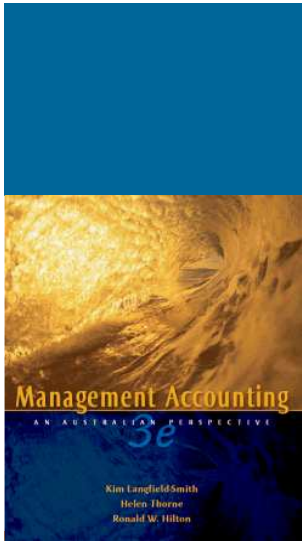
- ◆ Controlling profit and operations
 - ▲ The budget can serve as a benchmark to allow comparison with actual results
- ◆ Evaluating performance and providing incentives
 - ▲ Comparing actual result with budget provides a basis for evaluation of the performance of individuals, departments or the entire company
 - ▲ This can be linked to formal incentives, such as cash rewards, or profit sharing



Responsibility accounting

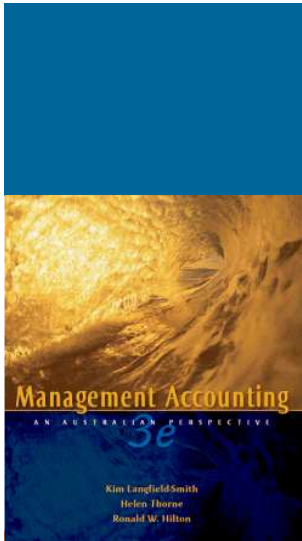
- ◆ Budgets are prepared along responsibility accounting lines
- ◆ Responsibility accounting
 - ▲ The practice of holding managers responsible for the activities and performance of their area of the business
- ◆ Managers of various departments
 - ▲ Develop their own budget estimates for cost, revenue or profits of their areas
 - ▲ Are then held responsible for meeting those budget targets

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Responsibility accounting

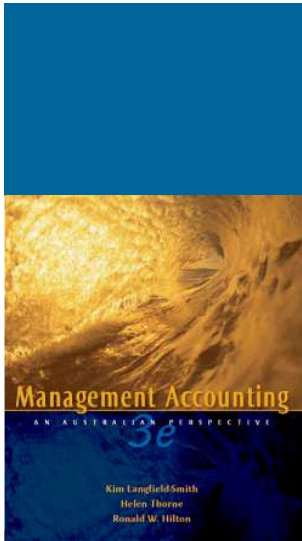
- ◆ Responsibility centres
 - ▶ A sub-unit of the organisation whose manager is held accountable for the sub-units' activities and performance
 - ▶ Cost centres, revenue centres, profit centre and investment centre
 - ▶ The type of responsibility centre determines the types of financial results for which a manager is held accountable



The annual budget

- ◆ The annual budget (or master budget) is a comprehensive set of budgets that cover all aspects of a firm's activities
 - ▲ Consists of several interdependent budgets

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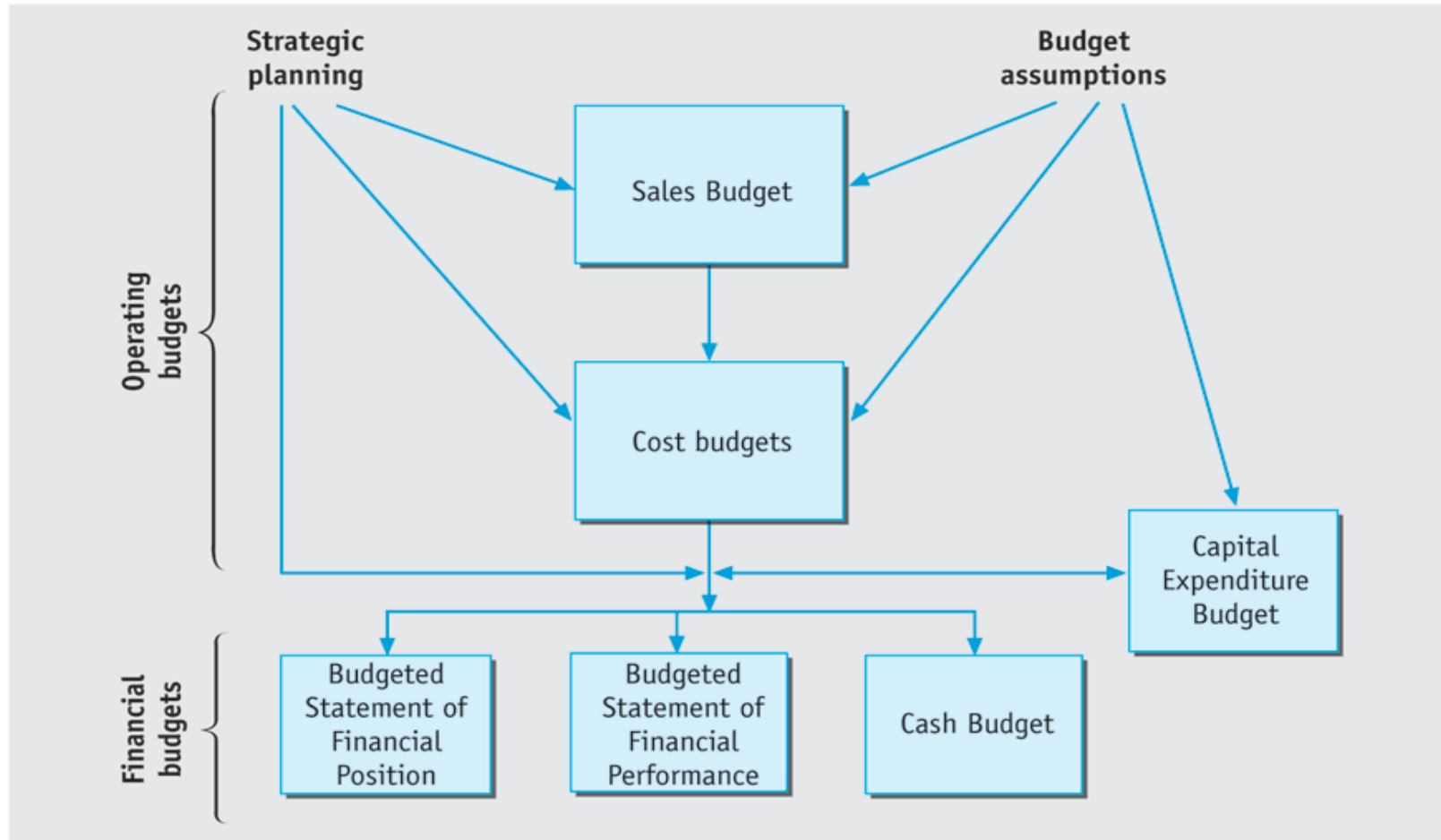
The annual budget

- ◆ *Operating budgets* include the sales budget and the various cost budgets
- ◆ The *financial budgets* consist of the budgeted statement of financial performance, the budgeted statement of financial position, the cash budgets and the capital expenditure budget

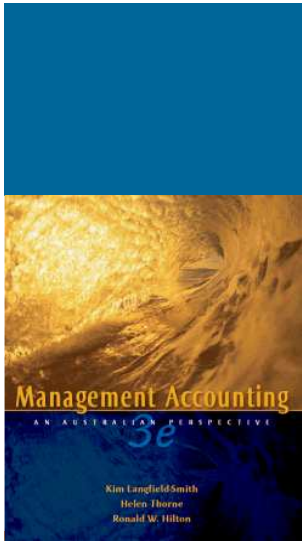
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The annual budget

EXHIBIT 9.1 Components of the annual budget



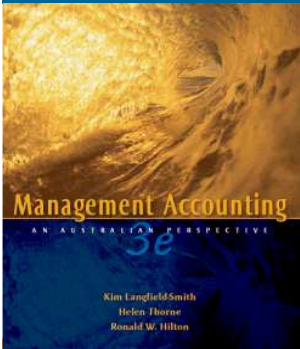
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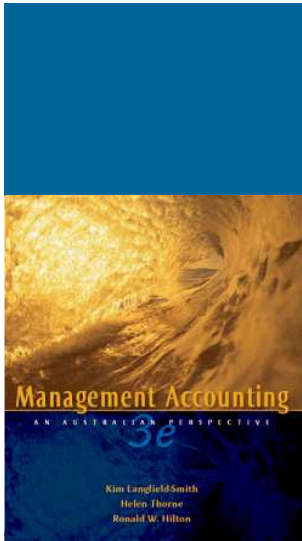
The annual budget

- ◆ Budgets are developed for specific time periods
- ◆ *Rolling budgets* (or continuous budgets) are continually updated by periodically adding a new time period, such as a quarter, and dropping the period just completed
- ◆ Budgets will vary in their level of detail, often dependent on the size and complexity of the organisation

Strategic plans and budget assumptions



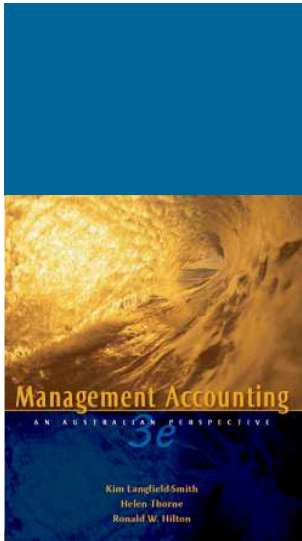
- ◆ Budgets must commence with an understanding of the strategy of the organisation
- ◆ The budget must be formulated in light of the strategic plans
- ◆ The budget is based on various assumptions about the competitive environment and the economic environment



The operating budgets

- ◆ The sales budget
 - ▶ a detailed summary of the estimated sales units and revenues from the organisation's products for the budget year
 - ▶ Based on the sales forecast, which involves estimating which products will be sold and in what quantities
 - ▶ Sales forecasting is a critical step in the budgeting process
 - ▶ Market research may be used

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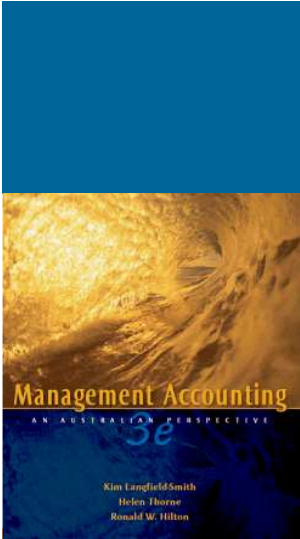


The operating budgets

◆ The sales budget

- ▲ Factors to consider when forecasting sales depend on the industry and nature of the firms, but will include
 - ▲ Internal factors: past sales levels, new products planned, intended pricing policy and planned advertising and promotion
 - ▲ External factors: general economic trends, specific industry trends, politic and legal events, expected activities of competitors and customers

continued



The operating budgets

- ◆ The cost budgets
 - ▲ Manufacturing firms
 - ❖ A production budget, which has cost budgets for direct materials, direct labour and overheads
 - ❖ Budgets for selling and administrative expenses
 - ▲ Retailers and wholesalers
 - ❖ A purchasing budget will be used to determine the quantity and cost of goods purchased for resale
 - ▲ Service firms
 - ❖ A set of budgets that show how demand for services will be met

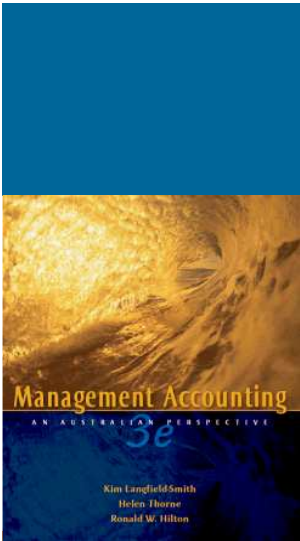
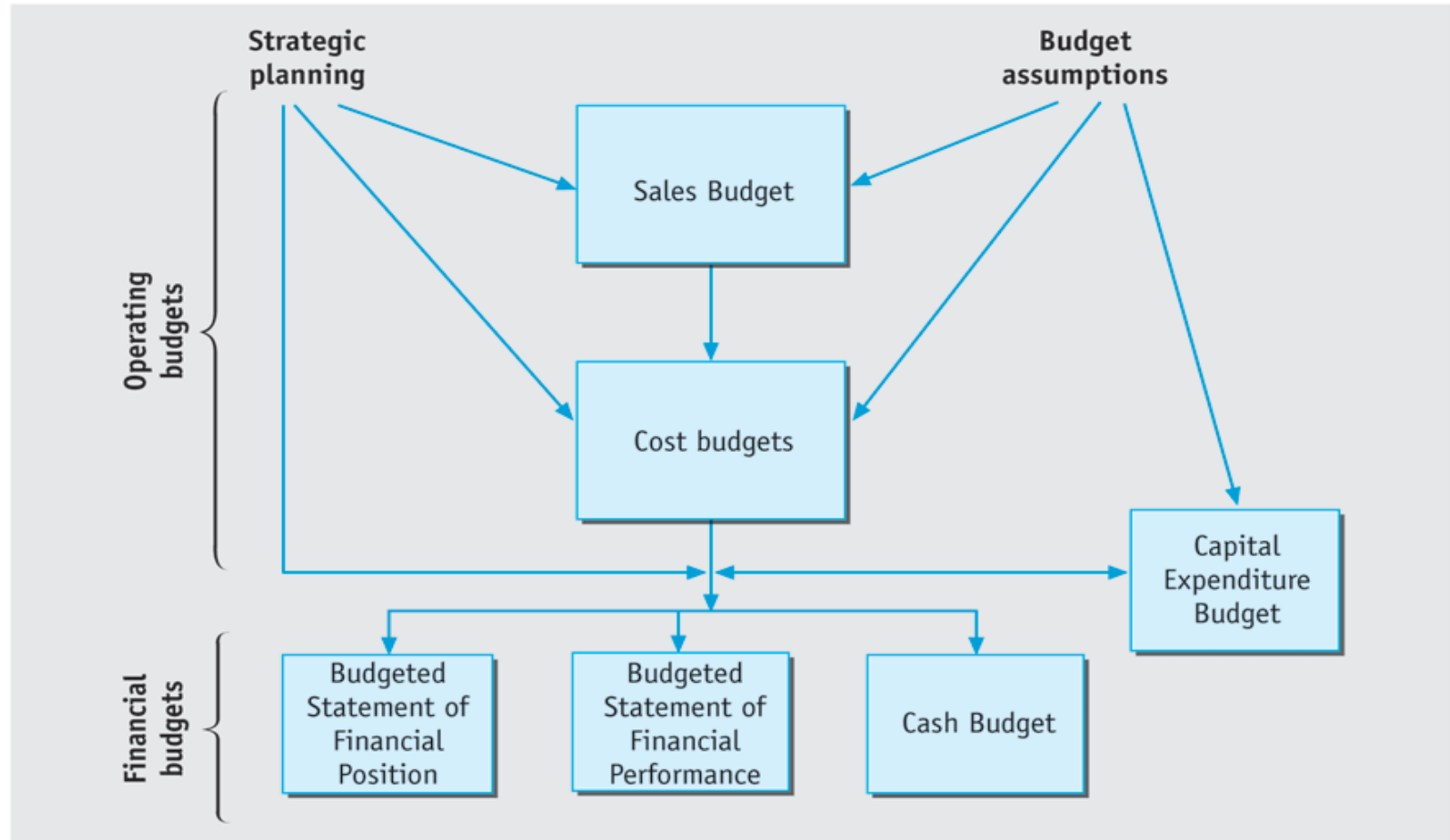
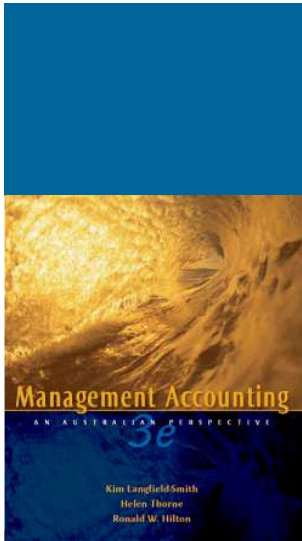


EXHIBIT 9.1 Components of the annual budget

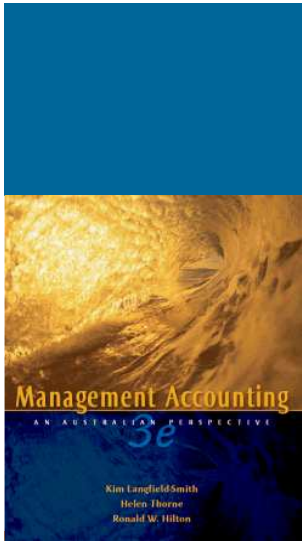




The financial budgets

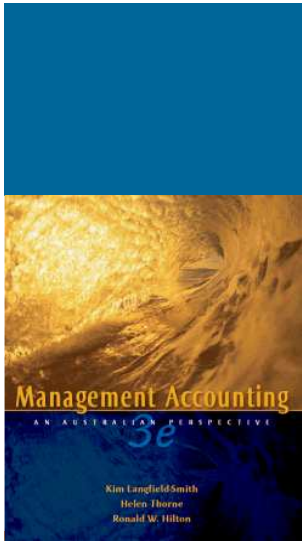
- ◆ The cash budget
 - ▲ Expected cash receipts and planned cash payments
 - ▲ Timing of all cash movements is important to identify cash shortages and cash surpluses
- ◆ Capital expenditure budget
 - ▲ A plan for the acquisition of the long-term assets, such as building, plant and equipment

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The financial budgets

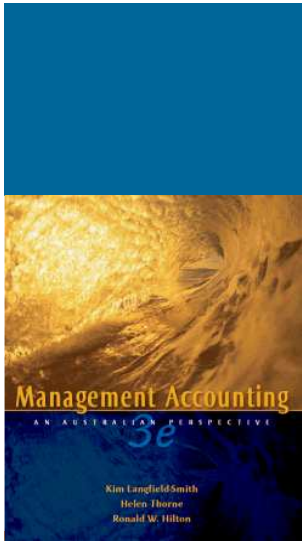
- ◆ Budgeted statement of financial performance
 - ▲ Shows expected revenues and planned expenses for the budget period
- ◆ Budgeted statement of financial position
 - ▲ Expected assets and liabilities at the end of the budget period
- ◆ Both statements may be broken down by quarter or month of the year



Budget administration

- ◆ In large organisations formal processes are often used to collect data and prepare the budget
- ◆ Budget administration is often the responsibility of the senior accounting managers

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Budget administration

- ◆ A budget manual may be developed to communicate who is responsible for providing various types of information, when the information is required and what form is it to take
- ◆ A budget committee is often appointed to advise the accountants during the preparation of the budget

Behavioural consequences of budgeting

- ◆ A budget affects virtually all staff in an organisation
 - ▶ those who prepare the budget,
 - ▶ those who use the budget for decision making and
 - ▶ those whose performance is evaluated using the budget
- ◆ Three main behavioural issues—budget participation, budgetary slack and budget difficulty

continued

Behavioural consequences of budgeting

- ◆ Participative budgeting
 - ▶ Allows managers at all levels of the firm to develop their own initial estimates for budgeted sales, costs, etc.
 - ▶ Top-down budgeting is where senior managers impose budget targets on more junior managers
 - ▶ Bottom-down budgeting is where people at the lower managerial and operations levels play an active part in setting their own budgets

continued

Behavioural consequences of budgeting

- ◆ Participative budgeting may...
 - ▶ Encourage coordination and communication between managers and a greater understanding and appreciation of the wider organisation
 - ▶ Lead to more accurate budget estimates as those close to the operations have the best knowledge of the likely sales or costs in their area
 - ▶ Can lead to individuals identifying more closely with the budget targets

continued

Behavioural consequences of budgeting

- ◆ Participative budgets
 - ▲ Can be expensive and time-consuming
 - ▲ Can lead to delay
 - ▲ May aggravate differences and disagreements
 - ▲ Provides opportunities for padding the budgets
- ◆ Employee empowerment is a wider concept than budgetary participation
 - ▲ Employees at all levels are given authority to develop their own budgets and targets, and manage their own work areas

continued

Behavioural consequences of budgeting

- ◆ Budgetary slack—padding the budget
 - ▲ Underestimating revenue or overestimating costs
 - ▲ The difference between the estimated revenue or cost projection, and a realistic estimate of the revenue or cost

continued

Behavioural consequences of budgeting

- ◆ Reasons for budgetary slack
 - ▶ Performance can look better if you can 'beat the budget'
 - ▶ A way of coping with uncertainty
 - ▶ To insulate against initial budget requests being cut back by management

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Behavioural consequences of budgeting

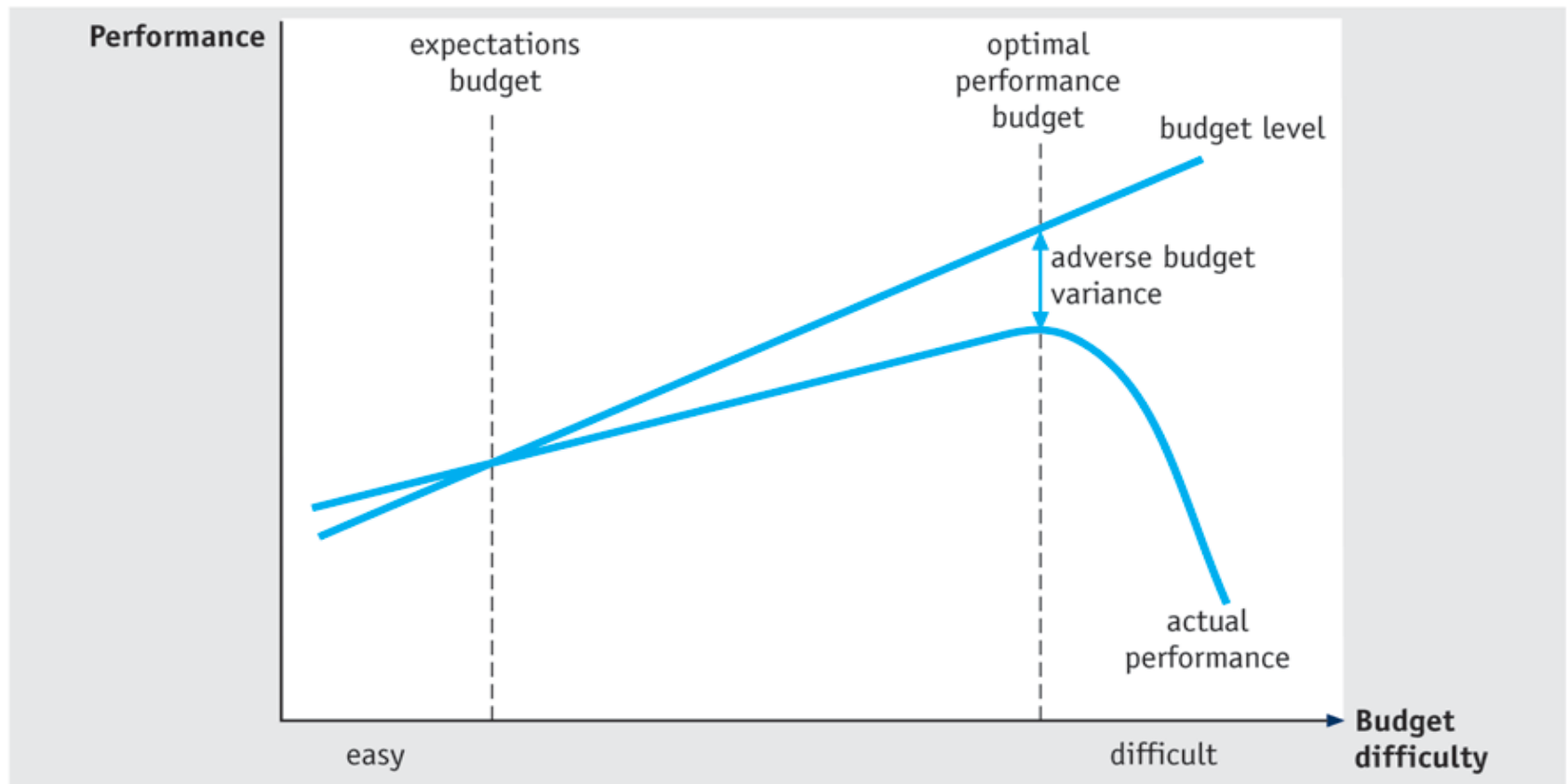
◆ Budget difficulty

▲ Budget acceptance is more likely when

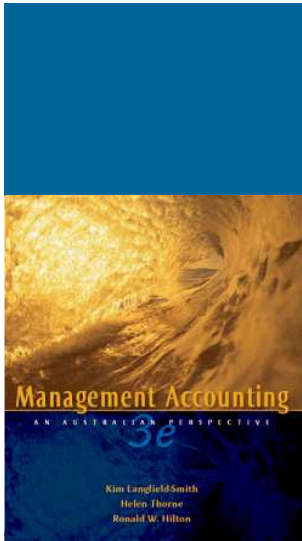
- ❖ Targets are developed with employee participation
- ❖ Targets are considered achievable
- ❖ There is frequent feedback on performance
- ❖ Employees are held responsible for activities that are within their control
- ❖ Achievement of targets is accompanied by rewards that are valued

▲ Budgets must be set at a level that provides challenge and stretch, but not too difficult

EXHIBIT 9.11 The effect of budget difficulty on employee performance

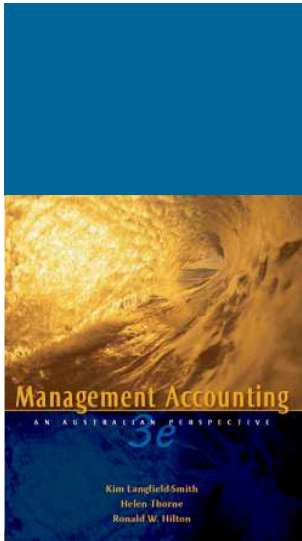


Source: Emmanuel, Otley & Merchant (1990, p. 173)



Zero based budgeting

- ◆ A process where all activities in the organisation are initially set to zero, and managers must justify each activity in term of its continued usefulness to the business to receive an allocation of resources
- ◆ A technique widely used in the 1970s and 1980s, particularly in government
- ◆ Can be expensive to implement
- ◆ Not useful in identifying areas of waste, redundant activities or ways to improve performance



Program budgeting

- ◆ Entails identifying the various program of the enterprise, developing objectives for each program and preparing budgets for each program
- ◆ Control is achieved through quantitative and qualitative performance measures that derive from the program objectives
- ◆ Associated with government departments
- ◆ Unlike line-item budgeting, the focus is on outputs not inputs