**Budgets and the Budgeting Cycle**

A budget is (a) the quantitative expression of a proposed plan of action by management for a specified period and (b) an aid to coordinate what needs to be done to implement that plan. A budget generally includes both financial and nonfinancial aspects of the plan, and it serves as a blueprint for the company to follow in an upcoming period. A financial budget quantifies management’s expectations regarding income, cash flows, and financial position. Just as financial statements are prepared for past periods, financial statements can be prepared for future periods—for example, a budgeted income statement, a budgeted statement of cash flows, and a budgeted balance sheet. Underlying these financial budgets are nonfinancial budgets for, say, units manufactured or sold, number of employees, and number of new products being introduced to the marketplace.

**Strategic Plans and Operating Plans**

Budgeting is most useful when it is integrated with a company’s strategy. Strategy specifies how an organization matches its own capabilities with the opportunities in the marketplace to accomplish its objectives. In developing successful strategies, managers consider questions such as the following:

* What are our objectives?
* How do we create value for our customers while distinguishing ourselves from our competitors?
* Are the markets for our products local, regional, national, or global? What trends affect our markets? How are we affected by the economy, our industry, and our competitors?
* What organizational and financial structures serve us best?
* What are the risks and opportunities of alternative strategies, and what are our contingency plans if our preferred plan fails?

A company, such as Home Depot, can have a strategy of providing quality products or services at a low price. Another company, such as Pfizer or Porsche, can have a strategy of providing a unique product or service that is priced higher than the products or services of competitors. Exhibit 6-1 shows that strategic plans are expressed through long-run budgets and operating plans are expressed via short-run budgets. But there is more to the story! The exhibit shows arrows pointing backward as well as forward. The backward arrows are a way of graphically indicating that budgets can lead to changes in plans and strategies. Budgets help managers assess strategic risks and opportunities by providing them with feedback about the likely effects of their strategies and plans. Sometimes the feedback signals to managers that they need to revise their plans and possibly their strategies. Boeing’s experience with the 747-8 program illustrates how budgets can help managers rework their operating plans. Boeing viewed updating its 747 jumbo jet by sharing design synergies with the ongoing 787 Dreamliner program as a relatively inexpensive way to take sales from Airbus’ A380 superjumbo jet. However, continued cost overruns and delays have undermined that strategy: The 747-8 program is already $2 billion over budget and a year behind schedule. The company recently revealed that it expects to earn no profit on virtually any of the 105 747-8 planes on its order books. With the budget for 2010 revealing higher-than expected

costs in design, rework, and production, Boeing has postponed plans to accelerate the jumbo’s production to 2013. Some aerospace experts are urging Boeing to consider more dramatic steps, including discontinuing the passenger aircraft version of the 747-8 program.



**Budgeting Cycle and Master Budget**

Well-managed companies usually cycle through the following budgeting steps during the course of the fiscal year:

1. Working together, managers and management accountants plan the performance of the company as a whole and the performance of its subunits (such as departments or divisions). Taking into account past performance and anticipated changes in the future, managers at all levels reach a common understanding on what is expected.

2. Senior managers give subordinate managers a frame of reference, a set of specific financial or nonfinancial expectations against which actual results will be compared.

3. Management accountants help managers investigate variations from plans, such as an unexpected decline in sales. If necessary, corrective action follows, such as a reduction in price to boost sales or cutting of costs to maintain profitability.

4. Managers and management accountants take into account market feedback, changed conditions, and their own experiences as they begin to make plans for the next period. For example, a decline in sales may cause managers to make changes in product features for the next period.

The preceding four steps describe the ongoing budget process. The working document at the core of this process is called the master budget. The master budget expresses management’s operating and financial plans for a specified period (usually a fiscal year), and it includes a set of budgeted financial statements. The master budget is the initial plan of what the company intends to accomplish in the budget period. The master budget evolves from both operating and financing decisions made by managers.

* Operating decisions deal with how to best use the limited resources of an organization.
* Financing decisions deal with how to obtain the funds to acquire those resources.

The terminology used to describe budgets varies among companies. For example, budgeted financial statements are sometimes called pro forma statements. Some companies, such as Hewlett-Packard, refer to budgeting as targeting. And many companies, such as Nissan Motor Company and Owens Corning, refer to the budget as a profit plan. Microsoft refers to goals as commitments and distributes firm-level goals across the company, connecting them to organizational, team, and ultimately individual commitments. This book’s focus centers on how management accounting helps managers make operating decisions, which is why this chapter emphasizes operating budgets. Managers spend a significant part of their time preparing and analyzing budgets. The many advantages of budgeting make spending time on the budgeting process a worthwhile investment of managers’ energies.

**Advantages of Budgets**

Budgets are an integral part of management control systems. When administered thoughtfully by managers, budgets do the following:

* Promote coordination and communication among subunits within the company
* Provide a framework for judging performance and facilitating learning
* Motivate managers and other employees

**Coordination and Communication**

Coordination is meshing and balancing all aspects of production or service and all departments in a company in the best way for the company to meet its goals. Communication is making sure those goals are understood by all employees. Coordination forces executives to think of relationships among individual departments within the company, as well as between the company and its supply chain partners. Consider budgeting at Pace, a United Kingdom-based manufacturer of electronic products. A key product is Pace’s digital set-top box for decoding satellite broadcasts. The production manager can achieve more timely production by coordinating and communicating with the company’s marketing team to understand when set-top boxes will be needed. In turn, the marketing team can make better predictions of future demand for set-top boxes by coordinating and communicating with Pace’s customers. Suppose BSkyB, one of Pace’s largest customers, is planning to launch a new high definition personal video recorder service. If Pace’s marketing group is able to obtain

information about the launch date for the service, it can share this information with Pace’s manufacturing group. The manufacturing group must then coordinate and communicate with Pace’s materials-procurement group, and so on. The point to understand is that Pace is more likely to have satisfied customers (by having personal video recorders in the demanded quantities at the times demanded) if Pace coordinates and communicates both within its business functions and with its suppliers and customers during the budgeting process as well as during the production process.

**Framework for Judging Performance and Facilitating Learning**

Budgets enable a company’s managers to measure actual performance against predicted performance. Budgets can overcome two limitations of using past performance as a basis for judging actual results. One limitation is that past results often incorporate past miscues and substandard performance. Consider a cellular telephone company (Mobile Communications) examining the current-year (2012) performance of its sales force. Suppose the performance for 2011 incorporated the efforts of many salespeople who have since left Mobile because they did not have a good understanding of the marketplace. (The president of Mobile said, “They could not sell ice cream in a heat wave.”) Using the sales record of those departed employees would set the performance bar for 2012 much too low. The other limitation of using past performance is that future conditions can be expected to differ from the past. Consider again Mobile Communications. Suppose, in 2012, Mobile had a 20% revenue increase, compared with a 10% revenue increase in 2011. Does this increase indicate outstanding sales performance? Before you say yes, consider the following facts. In November 2011, an industry trade association forecasts that

the 2012 growth rate in industry revenues will be 40%, which also turned out to be the actual growth rate. As a result, Mobile’s 20% actual revenue gain in 2012 takes on a negative connotation, even though it exceeded the 2011 actual growth rate of 10%. Using the 40% budgeted sales growth rate provides a better measure of the 2012 sales performance than using the 2011 actual growth rate of 10%. It is important to remember that a company’s budget should not be the only benchmark used to evaluate performance. Many companies also consider performance relative to peers as well as improvement over prior years. The problem with evaluating performance relative only to a budget is it creates an incentive for subordinates to set a target that is relatively easy to achieve.2 Of course, managers at all levels recognize this incentive, and therefore work to make the budget more challenging to achieve for the individuals who report to them. Negotiations occur among managers at each of these levels to understand what is possible and what is not. The budget is the end product of these negotiations. One of the most valuable benefits of budgeting is that it helps managers gather relevant information for improving future performance. When actual outcomes fall short of budgeted or planned results, it prompts thoughtful senior managers to ask questions about what happened and why, and how this knowledge can be used to ensure that such shortfalls do not occur again. This probing and learning is one of the most important reasons why budgeting helps improve performance.

**Motivating Managers and Other Employees**

Research shows that challenging budgets improve employee performance because employees view falling short of budgeted numbers as a failure. Most employees are motivated to work more intensely to avoid failure than to achieve success. As employees get closer to a goal, they work harder to achieve it. Therefore, many executives like to set demanding but achievable goals for their subordinate managers and employees. Creating a little anxiety improves performance, but overly ambitious and unachievable budgets increase anxiety without motivation because employees see little chance of avoiding failure. General Electric’s former CEO, Jack Welch, describes challenging, yet achievable, budgets as energizing, motivating, and satisfying for managers and other employees, and capable of unleashing out-of-the-box and creative thinking.

**Challenges in Administering Budgets**

The budgeting process involves all levels of management. Top managers want lower-level managers to participate in the budgeting process because lower-level managers have more specialized knowledge and first-hand experience with day-to-day aspects of running the business. Participation creates greater commitment and accountability toward the budget among lower-level managers. This is the bottom-up aspect of the budgeting process. The budgeting process, however, is a time-consuming one. It has been estimated that senior managers spend about 10% to 20% of their time on budgeting, and finance planning departments spend as much as 50% of their time on it.4 For most organizations, the annual budget process is a months-long exercise that consumes a tremendous amount of resources. Despite his admiration for setting challenging targets, Jack Welch has also

referred to the budgeting process as “the most ineffective process in management,” and as “the bane of corporate America.”

The widespread prevalence of budgets in companies ranging from major multinational corporations to small local businesses indicates that the advantages of budgeting systems outweigh the costs. To gain the benefits of budgeting, management at all levels of a company should understand and support the budget and all aspects of the management control system. This is critical for obtaining lower-level management’s participation in the

formulation of budgets and for successful administration of budgets. Lower-level managers who feel that top management does not “believe” in a budget are unlikely to be active participants in a budget process.

Budgets should not be administered rigidly. Attaining the budget is not an end in itself, especially when conditions change dramatically. A manager may commit to a budget, but if a situation arises in which some unplanned repairs or an unplanned advertising program would serve the long-run interests of the company, the manager should undertake the additional spending. On the flip side, the dramatic decline in consumer demand during the recent recession led designers such as Gucci to slash their ad budgets and put on hold planned new boutiques. Macy’s and other retailers, stuck with shelves of merchandise ordered before the financial crisis, had no recourse but to slash prices and cut their workforce. JCPenney eventually

missed its sales projections for 2008–09 by $2 billion. However, its aggressive actions during the year enabled it to survive the recession and emerge with sophisticated new inventory management plans to profit from the next holiday season.