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# **Budgeting Basics and Beyond**

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# Budgeting Basics and Beyond

*Fourth Edition*

JAE K. SHIM  
JOEL G. SIEGEL  
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*To Chung Shim, dedicated wife and mother;  
Roberta M. Siegel, loving wife and colleague;  
and Sylvia and Arnold Siegel, loving mother and brother*

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# Preface

**B**ETTER BUDGETS CAN BOOST your department and your career to higher levels of performance and success. Savvy executives use the budgeting process to take stock of their direction, refine their goals, and share their mission with their staff. Their budgeting reveals their position in the market, places untapped resources at their command, and motivates all employees to greater levels of productivity. They use their budgets to propel them toward the top of their industry. This book will show you how to get there.

*Budgeting Basics and Beyond* shows you how the budget can be your most powerful tool for strategy and communications. It points out that the budget brings into stark relief all of the factors that every manager must consider, such as industry conditions, competition, degree of risk, stability of operations, capacity limitations, pricing policies, turnover rates in assets, production conditions, product line and service considerations, inventory balances and condition, trends in the marketplace, number of employees and their technical abilities, availability and cost of raw materials, available physical resources, technological considerations, economy, and political aspects. Then it uncovers the role each of those factors plays in achieving your corporate goals. And since those goals cannot be achieved single-handedly, this book suggests ways to use the budget to help employees appreciate how they will contribute to the division's profitability. Aside from playing a vital role in creating and achieving a sound business strategy, this book shows how budgets can increase your effectiveness every day of the week. In particular, it delivers these on-the-job budgeting tools:

- Techniques for preparing more accurate, realistic, and reliable estimates
- Control and variance analysis devices that signal revenue, cost, and operations thresholds
- Pricing guidelines for products and services
- Planning and scheduling production and related costs

- Profit planning and identifying looming problems
- Financial models that show the relationship among all facets of the business
- Spreadsheet applications for planning, budgeting, and control purposes
- Sales and financial forecasting methodology
- Balanced scorecard and performance metrics

We follow the example of each of these tools with examples of how you can use them to make a difference in your work right away. And we use step-by-step guidelines to pinpoint what to look for, what to do, how to do it, and how to apply it on the job. Through step-by-step illustration, we show how you can put these tools to use.

While research shows that two-thirds of U.S. companies still rely on Microsoft Excel for their budgeting process, some companies are evolving to a more technologically advanced approach. As more and more companies operate globally, the Internet is playing an ever-greater role in the budgeting process. E-budgeting is an increasingly popular Internet- or intranet-based cloud-computing budgeting tool that can help streamline and speed up an organization's budgeting process. In addition, an increasing number of companies are turning to budgeting as a way to reduce costs for competitive advantage in a global environment.

In response to recent developments in budgeting, the fourth edition of the book features the following:

- Updated and additional hands-on examples throughout the book.
- Additional spreadsheet examples for budgeting, such as rolling budgets and probabilistic budgets.
- In depth e-budgeting and Web-based budgeting systems discussions.
- A new chapter, "Budgeting for Cost Management: Activity-Based Budgeting and Life-Cycle Budgeting."
- Budgeting in Action boxes in key chapters, offering a glimpse into how real companies use the budgeting tools and concepts discussed within the chapter.
- A companion web site. Please visit [www.wiley.com/go/budgetingbasics4e](http://www.wiley.com/go/budgetingbasics4e) to download supplementary materials to use alongside this book.

We hope that you will keep *Budgeting Basics and Beyond* handy for easy, quick reference and daily use.

# 1

CHAPTER ONE

## 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, and hours. 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 (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, 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 with 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 and economic conditions. 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 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 vary 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 the estimates.

Budgets link the nonfinancial plans and controls that constitute daily managerial operations with the corresponding plans and controls designed to obtain 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

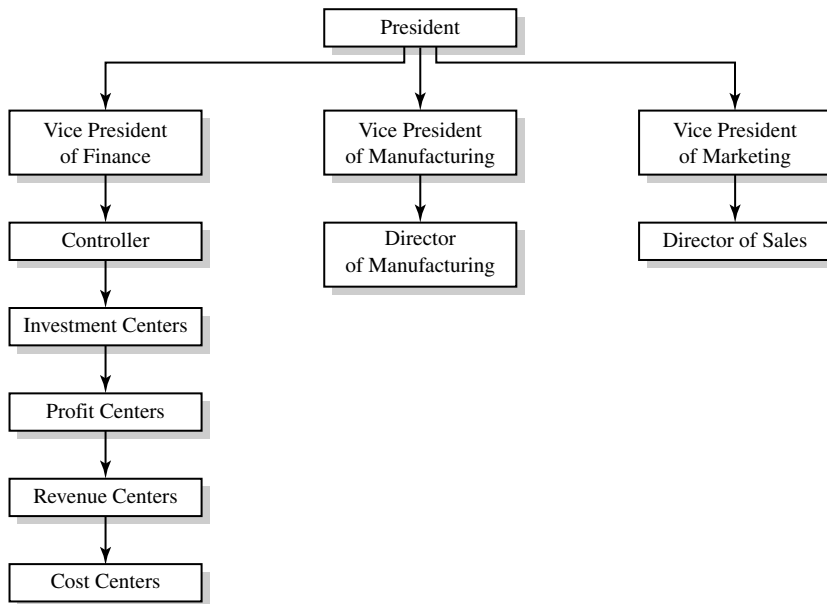
The budget should be reviewed by a group so that there is a broad knowledge base. Budget figures should be honest to ensure trust between the parties. At the corporate level, the budget examines sales and production to estimate corporate earnings and cash flow. At the department level, the budget examines 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, human resources, engineering, production, distribution, and facilities.

In budgeting, consideration should be given to the company's labor 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 are 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 also change. Internal factors are controllable by the company, whereas external factors usually cannot be controlled. Internal factors include risk and product innovation.



**EXHIBIT 1.1** Budget Segments

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 with which staff use it. 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, evaluation of 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, and 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 budget
- Operating and financial budgets
- Cash budget
- Static (fixed) budget
- Flexible (expense) budget
- Capital expenditure budget
- Program budget
- Incremental budget
- Add-on budget
- Supplemental budget
- Bracket budget
- Stretch budget
- Strategic budget
- Activity-based budget
- Target budget
- Rolling (continuous) budget
- Probabilistic budget

These budgets are briefly explained next.

## 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. It covers income statement items comprised of revenues and expenses. In contrast, the financial budget examines the expected assets, liabilities, and stockholders' equity of the business. It encompasses balance sheet items. Both budgets are 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 include appropriations for capital expenditures, major repair projects, and specific advertising or promotional programs. The static budget will be illustrated in Chapter 6, "Master Budget."

### **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. Flexible budgets are illustrated in Chapter 7, "Cost Behavior."

### **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

## BUDGETING IN ACTION

### Need for Flexible Budgets

The difficulty of accurately predicting future financial performance can be readily understood by reading the annual report of any publicly traded company. For example, Nucor Corporation, a steel manufacturer headquartered in Charlotte, North Carolina, cites numerous reasons why its actual results may differ from expectations, including: (1) the supply and cost of raw materials, electricity, and natural gas may change unexpectedly; (2) the market demand for steel products may change; (3) competitive pressures from imports and substitute materials may intensify; (4) uncertainties regarding the global economy may affect customer demand; (5) changes to U.S. and foreign trade policy may alter current importing and exporting practices; and (6) new government regulations could significantly increase environmental compliance costs. Each of these factors could cause static budget revenues and/or costs to differ from actual results.

*Source: Nucor Corporation 2010 annual report.*

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 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 which programs should 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.

## **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. Labor 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 with costs projected at higher and lower levels than the base amount. Sales are then forecasted for these levels. The purpose of this method is to provide management with a sense of earnings impact and a contingency expense plan if the base budget and the resulting sales forecast are not achieved. 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 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 and marketing personnel. Expenses may be estimated at the standard budget sales target. Many of the best-performing companies, such as GE and Microsoft, set stretch targets. Stretch targets are challenging but achievable levels of expected performance, intended to create a little discomfort and to motivate employees to exert extra effort and attain better performance. Firms such as Goldman Sachs also use “horizontal” stretch goal initiatives. The aim is to enhance professional development of employees by asking them to take on significantly different responsibilities or roles outside their comfort zone.

### 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 (ABB) estimates costs for individual activities. Traditional budgeting is functional budgeting because the focus is on preparing budgets by function, such as production, selling, and administrative support. Organizations that have implemented activity-based cost (ABC) systems often use these systems as a vehicle to prepare activity-based budgets that focus on the budgeted cost of activities required to produce and sell products and services. Activity-based budgeting is discussed at great length in Chapter 21, “Budgeting for Cost Management.”

### 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.

## Rolling (Continuous) Budget

A rolling budget, also called a *continuous* or *perpetual budget*, 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. In other words, one month (or quarter) is added to the end of the budget as each month (or quarter) comes to a close. This approach keeps managers focused at least one year ahead so that they do not become too narrowly focused on short-term results. Static (fixed) budgets are criticized as being ineffective in a rapidly changing world. Companies report performance on a calendar basis, but events such as floods, earthquakes, tsunamis, stock market crashes, strikes, and competitors' new product announcements 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 toward the future and ensure that planning is ongoing, as opposed to an annual exercise. The rolling budget largely eliminates the *budget revision* problem. Frequent restudy of plans is required by this approach. The rolling budget is illustrated in Chapter 19, "Using Software Packages and E-Budgeting."

## Probabilistic Budget

One way in which uncertainty can be explicitly introduced into the profit planning and control program is by the use of probabilistic profit budgets. Under this approach, several estimates are made for each of several key components in the budget, and probabilities are assigned to these estimates. One reasonable approach is to select an *optimistic*, a *pessimistic*, and a *most likely* estimate for each key number in the budget. This approach is illustrated in Chapter 19, "Using Software Packages and E-Budgeting."

## 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, the Program Evaluation and Review Technique (PERT), and Gantt charts 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. It 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 changes 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 for sales. After sales are forecasted, 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



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