Budgeting

Budgets and Organizational Architecture

- A budget is management's forecast of revenues, expenses, or profits in a future time period.
- Knowledge: Budgets communicate key planning assumptions such as product prices, units sales, and input prices.
- Partition Decision Rights: Budget sets guidelines on resources available for each segment.
- Performance Evaluation: Responsibility center's actual performance is compared to budget.

Variances:

- A statistic that describes the differences between the observations and the predictions.
- A managerial accounting term: the difference between the budgeted and actual amount.
- Related, but distinct. Managerial accounting variances are more closely related to 'errors' in statistics.

Variances:

- Variances are termed 'favorable' and 'unfavorable' based on their impact on income.

- Keep in mind that budgets are plans, so any variance is evidence that things did not go according to plan.

- Favorable (F) variance: actual revenue > budgeted revenue actual expense < budgeted expense

- Unfavorable (U) variance: actual revenue < budgeted revenue actual expense > budgeted expense

Example: Country Club

- Responsibility Centers: 1 profit center and 2 cost centers
- Measurement: Monthly reports compare actual revenues and expenses to budget.

- Budget process separates decision rights. Initiation and implementation by professional managers. Ratification and monitoring by Board of Directors and members.

Example: Private University

Responsibility centers in 4 colleges: 2 cost centers, 2 profit centers. Knowledge: Number of students drives revenue forecasts. Faculty market drives faculty salary expense. Decision rights:
Lower levels prepare initial budgets. Higher levels review and ratify budget. Agency problems:
Empire building: request "too large" a budget. Externalities: Cost centers are more likely to add unprofitable programs than profit centers.

Is Auxiliary Services a responsibility center? How should it be evaluated?

Example: Large Corporation

Responsibility centers: 2 cost (manufacturing and marketing) 1 profit (paper and toner supplies)

Knowledge:
Vertical transfers (lower to higher levels) Horizontal transfers (marketing to manufacturing) Identify potential bottlenecks in production Identify financing needs

Contracting: Budgets are internal contracts between operating segments Divisional managers negotiate budgets Executive managers negotiate disputes and review budgets for consistency with corporate strategy

Trade-off: Communication vs. Evaluation

Budgets are used for both decision management and decision control.

Optimal decision making requires managers fully reveal private knowledge about production and market conditions during budget negotiations.

When budgets are also used for performance evaluation, managers have an incentive to make biased budget forecasts so that their actual performance will look good relative to budget.

Budget Ratcheting

Ratchet effect: Basing next year's standard of performance on this year's actual performance.

Disadvantages: Performance targets usually adjusted upward Employees reduce output to avoid being held to higher standards in the future

Possible Solution: Eliminate budget targets Estimate next year's sales More frequent job rotation

Summary: While the ratchet effect creates dysfunctional behavior, the alternatives might produce even greater problems.

Trade-off: Bottom-up vs. Top-down

Top-down budgets: Knowledge: Top management can make accurate aggregate forecasts Decision rights: Begin with aggregate forecasts for firm, and then disaggregate down to lower levels Decision control more important than decision management

Bottom-up budgets (participative budgeting): Knowledge: Lower levels have more knowledge than top Decision rights: Person being held responsible for meeting the target makes the initial budget forecast Decision management more important than decision control

New Approaches to Budgeting

Building the budget in two distinct steps Step 1: Construct budgets in operational terms (Lowest levels of the organization) Step 2: Developing a financial plan based on the operational plans from Step 1.

Constructing budgets for financial planning (decision management), but not using budgets as performance targets (decision control) Units are judged by comparing their actual performance with the actual performance of defined "peer units". Actual rewards can include consideration of both financial and non-financial performance measures.

Discuss the Following Assertions

No simple "one-size-fits-all" panacea exists for resolving the conflict between decision management versus decision control when it comes to budgeting.

Nor is such a solution ever likely to be found.

Trade-off: Resolving Disagreements

Top executive officers of firms have final decision rights over the entire budget process.

Top executives resolve disputes among lower levels.

After adoption, the budget is an informal set of contracts among the various units of the firm.

Short-run vs. Long-run

Firms that use only short-term (annual) budgets do not create adequate incentives for long-term maintenance and responding to new opportunities.

Strategic planning requires long-term budgets (2, 5, or 10 years).

Financial lending institutions often require cash flow projections for the length of any proposed borrowing.

Many firms require managers to prepare both short-term and long-term budgets as part of the periodic budget review.

Line-Item Budgets

Line-item budgets authorize managers to spend only up to the specified amount on each line item.

Advantages: Tight control reduces opportunities for managers to take actions inconsistent with firm goals

Disadvantages: Inflexible in responding to unanticipated needs Little incentive for cost savings

Facilitating Rolling Budgets

Cisco uses an 18-month rolling budget versus a static budget.

Advantages: Keeps budget more current in a changing environment Managers may react in a more timely manner by better integrating planning and execution.

Disadvantages: Costs of software and management time Key Solution: Use a single standardized web page for data entry and automatic roll up to the company-wide budget.

Budget Lapsing

Budget lapsing is a requirement that funds allocated for a particular year cannot be carried over to the following year.

Advantages: Tighter control than budgets that do not lapse Prevents risk-averse managers from accumulating funds

Disadvantages: Encourages wasteful spending near end of fiscal year

Static Budgets

Do not vary with volume, such as costs that should be fixed

Volume changes may create budget variances

Since managers are not insulated from volume changes, they have incentives to mitigate impact of adverse volume changes

Flexible Budgets

Do adjust for changes in volume, such as semivariable costs that include a fixed and variable component

Evaluate performance after adjusting for volume effects

Manager is not held responsible for volume changes

See Self-Study Problems.

Incremental vs. Zero-Based Budgets

Incremental budgeting: Begin with current year's core budget and make incremental changes Review focuses on incremental changes and may ignore inefficiencies in core budget

Zero-based budgeting (ZBB): Mandates each line item in total must be justified each year Motivates managers to eliminate inefficient expenses Useful when firm is changing strategic direction Becomes less useful when same justifications are used each year

Appendix: Master Budget Example

Study Figure 6-3.

Logical relationships Sales budget drives production and purchasing Production drives materials and labor budget Production and sales drive inventory and cost of goods sold

Master budget statements Budgeted income statement Budgeted balance sheet Budgeted cash flows

Budgets and Economic Darwinism

Budgets may result in suboptimal performance because: Too much emphasis on financial rather than nonfinancial measures Short-term rather long-term results Maximizing incentive bonuses for manager rather than firm value Too much time analyzing budget variances

Despite all these problems, budgets persist in firms.

The economic Darwinism principle implies budgeting must be yielding benefits at least as large as their costs.