Budgeting And The Middle Manager

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I The Role of Budgeting in The Management Process

The role that budgeting plays in the management of a business is best understood when related to the fundamentals of management. The many existing definitions of business management can be expressed in terms of three major functions: planning, execution, and control. Those are the key elements of the management process. Business (or, for that matter, any organization) managers must plan their activities in advance, carry out the plan, and institute appropriate techniques of observation and reporting to insure that the deviations from plan are properly analyzed and handled.

A budget can be regarded as primarily a plan or goal/objective, and we know of no better definition of budgeting than to say that a budget is a *planning and control system*. Each word in that definition is important for a full understanding of budgeting's proper role. The planning and control aspects relate to the fundamentals of the management process mentioned previously. To regard budgeting as a system is most important, because this implies a continuing process throughout the year — the key to good budgeting in any business operation.

II A Management Definition of Budgeting

A budget is simply a plan that expresses business goals in quantifiable terms.
A good budgeting program will take both a short range (tactical) and a long range (strategic) perspective. Short range planning entails operating expense and revenue and, in profit oriented organizations, cash flow budgets. Long range budgeting involves the capital outlay process.

Contrary to some views, budgeting is not an accounting function performed by budget departments, bookkeepers, or accountants. They merely record and report plans and comparisons of operating results with those plans; they help management analyze, interpret, and react. But budgeting, in of itself, is a *management function*. Many companies complain about the lack of effectiveness of their budgets. But their "budgets" are little more than forecasts, all too often prepared by the finance department and not by the operating personnel; the result is a superficial set of figures rather than a “grass-roots” budget.

III Budgeting as a Processor

The “Budgeting Process” has two important functions. First, it is a tool for planning. Second, it is a means of implementing control over operations and the coordination of diverse tasks.

Budgets, by definition, represent restrictions and, therefore, used as criteria for the measurement of success and failure. It becomes important for all members of the management team to “buy into” the budget process. This requires agreement and commitment to the goals and objectives of the organization. It also suggests that there must be a high level of cooperation among those who are competing for the budget dollar.

Traditionally, there has always been a certain amount of *gamesmanship* during the budgeting process. Much of this occurs because most managers are unfamiliar with the process itself. They have come to believe that the only way that they can receive the level of funding required to operate their respective functional units is to request far more budget than is needed. They then expect that the Senior Executive to cut them back. They hope that when all is settled, they will be funded at a level with which they can live.

It is incumbent upon the budget manager of any organization to provide a system for his/her unit that will satisfy a number of basic criteria. These include the integration of the day-to-day operating plan with the overall goals and objectives of the enterprise. If a *least cost* budget were always offered, gamesmanship would very quickly die a natural death.

IV Types of Budgets

A. Operating Budgets

Operating budgets begin with the development of a reliable revenue forecast. This leads to four sets of operating plans: operations, marketing, field operations (if applicable), and general management. Each of these has numerous sub-budgets. For example, operating plans would entail production budgets, and various expense budgets. Marketing plans, on the other hand, would include an advertising budget and a selling expense budget.

Operating sub-budgets become meaningful when they are fully coordinated into an overall set of forecasted financial statements—i.e., into an overall plan expressed in a *pro-forma* statement basis.

B. Flexible or Variable Budgets

In some instances, costs reflected in operating budgets will vary with the volume of output. This is most typical in production departments. Where this is the case, flexibility is often injected into budgeting through the use of variable budgets.

Variable budgets recognize that while some costs might be fixed, others may be variable. Thus, this approach plans for the expected behavior of costs at various levels of output. For example, it might be prudent to budget for (at least) three levels of output: medium, high, and low; or it might become necessary to budget for all levels of production such as ten percent to 120 percent of capacity. The key to variable budgeting is the development of a reliable relationship between output and the expense or cost involved (or to clearly understand the *cost drivers*). Statistical regression techniques are a powerful tool in accomplishing this.

In any budgeting system, allowances must be made for the kinds of costs involved. Generally, there are three specific types of costs operating within any budget system. These are:

- Variable Costs
- Fixed Costs
- Semi-Variable, or Semi-Fixed

Variable costs are those that fluctuate in some direct relationship, activity, or volume. The greater the level of activity, the greater the cost. An easy example is gasoline usage. The more that the car is used; the greater the amount of fuel is consumed.

Fixed costs are those that remain stable for long periods of time. For example, rental fees are usually considered to be fixed expenditures. In for-profit companies, fixed costs are described as those costs that are present before the doors are open.

Semi-variable costs fluctuate without regard to levels of output. Energy costs, heating and cooling, for example, rise and fall based on seasonality, not on levels of production.

C. Cash Budgets

The cash budget is used for forecasting the flow of cash through the organization. It provides an excellent means for managing liquidity by focusing on the analysis of cash receipts and cash disbursements. Cash budgeting also looks closely at the timing relationships to the movement of cash, in and out.

VIII Making Budgets Work

The secrets of making budgets work for you lie in the effectiveness of reporting and in the insight into operations provided by variances from budget/plan. What is done about variances is a matter of management judgment that often makes the difference between a profitable year or and a loss year.

The budgeting effort can be effective only if the results are reported in such a manner that they gain the necessary attention from all levels of management. Here are some basic guides that should be followed in preparing budget reports:

- Only those items of cost that are actually incurred by the individual charged with the responsibility for a particular department should be included in the budget report for that department. Avoid including allocations of general overhead or other items over which the department has no control.

- Only that information that is meaningful and necessary should be included in the report.

- Only the minimum amount of detail appropriate for the organizational level for which the report is intended should be included.

- Accounting and reporting of expenditures should be in accordance with principles of general responsibility reporting as followed by your company.

If these guidelines are followed, one can gain the acceptability that is required and the attention that is necessary for effective use of budgets as herein described.