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# Budget Cost Controls for the Smaller Company

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*Presented before the Saint Louis Chapter of the  
National Association of Accountants — November 1963*

**A**LL of you, of course, are generally familiar with budgets and their purposes, and as you know, budget preparation and budget administration require taking many things into account and much reflection. Budgetary control reaches into all branches of the organization and operation of the business. It is not easy to do a worth-while budgeting job. In many companies it is a highly complex process.

Budgeting is a very effective instrument of internal control. The degree of control is certainly greater where there is an organized system of accountability for results. Under such a system people must do more than approve expenditures. They must do more than take other actions affecting the business position. They must also account for the results of their actions in some formal and organized way.

It does not necessarily follow, however, merely because a company has what it calls a budget system, that the internal control is better than it would otherwise be. A company may go through certain procedures and prepare certain reports that are collectively described as budgetary control. The so-called system may be nothing more than a rough forecast not intended to control. It may be too loosely constituted to provide an effective basis of control.

## OBJECTIVES

What is a company attempting to do when it employs budgetary control? Fundamentally, it is attempting to make better decisions and to make them more promptly. It is seeking to conserve the time, and thus improve the effectiveness, of the important people in the business.

There are two ways to run a business: by plan, or by chance. The first way, management appraises the situation and the problems of the business at appropriate intervals. It decides what it is going to do and reviews the performance. It revises its decisions if there are unexpected developments. This way, management is always on top of the situation. It knows, and the organization knows, where the business is trying to go and how it plans to get there. The whole posture of the organization inclines forward. Future conditions and problems are anticipated insofar as advance observation and action are possible. People are given definite goals to strive for. This

stimulation is very different from saying, "Try hard and do the best you can."

In a complex operation, all this pre-arranging takes a lot of thinking, and a lot of time. No one person or small group of persons can do it all. No one person can acquire the knowledge, in fine detail, of all the factors entering into the many decisions. It takes an organization-wide effort to gather the facts, weigh the probabilities, and reach a judgment. To a certain extent, people must rely on each other—there is no other way.

This, in essence, is budgetary control. Underlying everything there must obviously be a clear understanding of "Who is to do what." There must be some ground rules on how various things are to be done. This is the area of organization planning and policy with which we are not concerned at this time. We should keep in mind, however, that we cannot have effective budgetary control unless authority and responsibility in the organization structure are clearly defined.

There are two tests that determine the relative effectiveness of a budget system. The first is sensitivity; the second, reaction time. As to sensitivity, the test is this: How quickly, and how thoroughly, are changes from anticipated results detected, diagnosed, and reported to the people who should do something about them? For example, once a month may be too late to find out what is happening to sales; once a week may be too late to follow up on a new production process. On the other hand, every two or three months may be often enough to take a close look at research projects. The system should not only tell us what we need to know, but also—and this is important—when we need to know, to make timely decisions.

As to reaction time, the questions are these: How adequate is the information system, and how much flexibility does it have for measuring the effects of alternative decisions? Do we have the means of finding out promptly the things that are going on? Are we able to decide quickly what, if anything, should be done about them? For example, can we find out—sometimes in a hurry—what will be the effect of a change in the design of a product or the use of a new material; what might be the effect of a change in prices or wage rates; what might be the effect of operating on overtime as compared with the cost of accumulating inventory in slack periods? Does the system give us a reasonable appraisal of such effects, or must we largely guess when we make a decision one way or the other?

Not every business is complex and not every operation needs an elaborate system of control. Over-enthusiasm on control may reach

the point where management is running a system instead of a business. The degree of control and the complexity of the system bring us back again to our fundamental objectives. What does the business need in order to make better decisions, and to make decisions promptly? How can it conserve the time, and so enhance the effectiveness, of the important people in the business?

The other way to run a business may be expressed in two words—to drift. This is exaggerating slightly, because all managements give some thought to what may happen. They may also give some further thought to what they would do if this or that happened. Generally, however, without an organized system of planning and control, decisions are made when they cannot be deferred, and problems are met as they arise.

Such an approach is not likely to bring forth the best efforts of the people in the organization. Most people respond to a challenge. They like to be held responsible and accountable for a certain result. This causes people to think more about their jobs and to do them better.

An unplanned operation is wasteful because it fails to make full use of the abilities in the organization. There are necessary limitations to what men at the top can know about the business. They simply haven't the time to find out about everything. There is all the difference in the world between these approaches—one, where all the responsible people in the organization are put to work at thinking about what can be done; the other, where people below the top are relegated largely to handling their work as it comes to them. Participation in the planning process, coupled with responsibility for results, generates a sense of drive throughout the organization. There is much better direction of effort. There is bound to be better performance.

This does not mean that a disproportionate amount of time should be spent on planning and control. These procedures should not needlessly interfere with the business. The work that counts, the day-to-day buying, making, and selling, must be done. Control must not be an encumbrance. We need just enough of it so that people may go about their work with a sense of purpose. They should have a means of knowing whether they are doing a good job. They need an incentive to do a better one.

#### **PROBLEMS IN ACHIEVING BUDGETARY CONTROL**

There are two main problems in achieving effective budgetary control. The first, and by far the more important, is obtaining support from the top of the organization. The men who have the power to

decide what will be done must support the concept in principle. They themselves must use the budgetary plan in shaping their own decisions and in supervising the work of others. The business must be run as the system contemplates that it will be run. The rules must apply all the way up to and including the top.

Unless people down the line know this, budgetary control is not likely to be taken very seriously. A lot of work may be done, and some good may be accomplished. As time goes on, however, the effort will be a half-hearted one and will produce diminishing returns. People must feel that the system is a significant influence in running the business. They should feel that their own progress depends on how well they plan and control their own activities.

The second main problem in achieving effective budgetary control is primarily a technical one. It is the collection, organization, and dissemination of the information needed in shaping the plans and making the decisions. There must be an adequate information structure.

Within these two basic problems, or closely related to them, are other subsidiary problems. One is inertia—the reluctance to change, particularly when things are going pretty well. The answer to this is that rarely, if ever, is improvement beyond reach. Another is fear—fear of the inability to plan precisely and reluctance to deal with frictions that may occur. The answer to this is that worth-while accomplishment of any kind does not often come easily. A similar obstacle may be the feeling that budgetary control entails too much trouble and expense. Freedom from trouble cannot be guaranteed; in fact, benefit may come from dealing with the trouble. The expense factor should, of course, be viewed practically. Budgeting is not an end in itself. It is not something to provide work for accountants or other technicians. Its justification must rest upon its usefulness.

Budgetary control is sometimes impeded by faulty organization. We are face to face with such a situation right now in an old-line company. A new president, who is used to a budgetary control system, wants one installed in this company. He is not yet ready to tackle some organizational problems of which, nevertheless, he is well aware.

## **DEVELOPING THE SYSTEM**

What has been said heretofore has been concerned with the theory or philosophy of budgeting—what a company is trying to accomplish through budgetary control and the problems that may

appear along the way. Now, as to how the budget is put together and what is done with it.

### **General**

The direction of budgetary planning and control should be upward and not downward. That is, budget preparation, review, and later follow-up on performance, should start at the lowest level in the organization. It should move upward from there. A second general principle is that the lines of budgetary control should coincide with those of organizational responsibilities.

Depending on the size of the company, the initial development of a budgetary plan probably will require anywhere from four to six months. About three months will be required to develop completely and to approve the budget each year. Probably two more months will be required during the first time through.

The first step is a meeting with all members of the executive management group to discuss with them the objectives of profit planning. The part these people should play in the development of the planning system needs to be clearly defined. At the same time a letter should be sent to all key employees, discussing the same points covered in the management meeting. This letter should be general in scope and need not cover specific planning details. These can be given in a later memorandum accompanying the budget requests.

It is important at the outset to review the organization structure of the company. The degree of responsibility for the financial success of the company should be established for various levels of management. Responsibility code numbers should be assigned to each profit center to serve as its accounting identity. Major, intermediate, and minor levels of responsibility should be recognized in a logical sequence of numbers.

It is not uncommon to find that a company plans its operations by responsibility, but prepares its financial statements by account classification. Control of performance requires the use of responsibility accounting to produce financial statements comparing performance with plans.

The process of accounting for responsibility requires an organization code to be associated with an account code in each transaction. An organization code is supplied to indicate the profit center where the particular cost is incurred. An account number is assigned to represent the natural expense classification. Expenses may be coded

to the lowest organizational unit, as expenses are normally incurred by individuals working in these areas. It is not always possible, nor it is always desirable, to code income to the lowest organizational levels. A decision should be made concerning which groups will have income responsibility.

Charges should be made to operating departments for services performed. Offsetting credits will act as a reduction of service department expense. From a technical standpoint, it is better to consider these credits as a reduction of expense, rather than as revenue.

Usually some revision of the chart of accounts will be required. The chart should provide account numbers in a logical sequence to provide appropriate summarization. Reports can then be prepared automatically without supplemental reclassifications.

### **Budget Components**

The key component in the budget structure is the sales forecast. Since production and other costs are dependent on sales volume, the forecasting of sales obviously warrants careful effort. Sales budgets should be prepared both in units of products and in dollars. They should be detailed as to territories, customers, or other appropriate segregations.

The second major component is the production budget. The general guides to planning production are the sales forecasts, the capacity of the plant facilities, and the desired inventory position. In the first stage of the production budget, these sales units are converted into equivalent production.

To translate the planned production levels in physical units into dollars, there must be some basis for estimating probable costs. Factory cost control, an important area in itself, ties in with budget planning by providing the cost criteria and the later follow-up on performance.

The third major component is marketing and distribution cost. This area offers fruitful opportunities for improvements in control. The development of distribution cost analysis has proceeded slowly. It needs to be accelerated because of the increasing importance of these costs.

Completion of the sales and production budgets will indicate the anticipated level of activity in the company. Department heads can then undertake the preparation of operating expense budgets. Department heads are usually familiar with the direct costs of their

departments. Other costs, such as depreciation, insurance, and taxes, can be added after the budgets have been submitted.

Service departments, such as maintenance, and repair shops, need to know the anticipated demand for their services to be able to prepare their budgets for the coming year. This information will also provide management with some basis for controlling the size of these departments. It is relatively easy for costs to get out of control in service departments unless charges are made for their services to the operating departments on reasonable bases. The performance of the service department can be measured by comparing the charges made to the operating departments on work orders with the actual costs of the service department.

When salaries and wages are budgeted, each employee should be considered as responsible to only one manager for his employment status, even though he may work part time in other departments.

### **Budget Review and Approval**

To put these various components together requires a lot of hard thought. Matters of policy and many points of detail have to be resolved. Budgeting compels management to study its markets, its facilities, its policies, and its methods of operating at regular intervals and to concentrate upon better ways of doing things. The psychology of this works in somewhat the same way as the principle of compulsory saving. The objective will be reached under discipline, but perhaps not otherwise.

Nor is the job finished when the department or division completes its budget and passes it on to the next higher level. The decisions become tougher as the budget moves up the line. At the originating levels, the budgets may be tight, loose, or a compromise. At the next stage, explanation and justification from the lower levels come up against critical review at the next higher level. And so on, all the way to the top. Here, more than anywhere else in the budget process, is where the men are separated from the boys. Here is where management, with the benefit of all the knowledge in the organization, decides what the business shall try to do. To find the right answer may be exceedingly difficult. It requires striking a proper balance. The end result, the budget that is approved, should be realistic in the sense that it is believed to be attainable. At the same time, it should set a target that people will have to work hard to reach.

Very few plans can survive for a full year without change. It is

important to build into a system the means of recognizing anticipated changes so that the plan will be flexible. In general, changes should be recognized in much the same manner as the original budget is developed, requiring approval at each management level.

### **Performance—Review and Reports**

Approval of the budget sets in motion all the activities envisaged in working to the planned result. As we move along in the budget period, we need to know whether our plans are working out as scheduled, and, if not, why not? We need to know so that we may decide what action, if any, we are going to take. Should we correct what we have been doing, or should we change our plans? What we are looking for are the trouble spots, or, as it is sometimes expressed, exercising control by exception. That is, we pass quickly over the occurrences that coincide with the plan and concentrate on the performance that is not according to plan.

In terms of characteristics, or features of the control system, what do we need to do this? Two things—first, we need adequate and timely reports to locate the trouble spots, and second, we need what might be informally referred to as organized needling.

We could talk at length about reports, but most of what might be said comes down to this: The people at the various levels of management should receive reports at appropriate times telling them what they need to know concerning their areas of responsibility. The reports should be to the point and not cluttered up with non-essentials. Timeliness, obviously, is of great practical importance. Generally, good news can wait a bit, but news about trouble must be given top priority.

The organized needling serves a constructive purpose. This is to make sure that trouble shooting is taken care of, the causes run down, and the corrections made. In effect, each level of management says to the level immediately below, "What caused this and what are you doing about it?"

This is a necessary procedure as well as a constructive one. It is necessary because human nature is what it is. The person with the immediate responsibility will do something if he knows someone is going to be checking up on the matter. He might not do anything if he thought that he would not hear further.

This does not mean that control over performance is essentially a process of asking unpleasant questions and debating the answers. The necessary questions should be asked and discussed. The

important point is that everyone benefits from knowing promptly what the problems are. They benefit from the organized effort that is made to meet them.

### **OPPORTUNITIES FOR CONSTRUCTIVE SERVICE**

This concludes my observations on highlights of budgetary control. What I have tried to do is to emphasize the meaningful aspects and advantages of control, in practical terms. I have said comparatively little about how the figures are put together. This is not because this is unimportant or by any means free of complexity. You should remember that the non-financial executive has comparatively little interest in that aspect of the subject. What he wants to know is why budgetary control is a good thing for his business; how will it affect the way the business is run; how much will it cost; and will the benefits exceed the cost.

We must remember that few business executives see budgeting—or, for that matter, other accounting techniques—through the eyes, or from the viewpoint, of the accountant. Most of the top executives in important businesses are sales or production men, with lawyers probably running third in number. Almost none of them have the fascination for figures, or the interest in accounting methods and theories, that we accountants have. If we attempt to talk to these men primarily in accounting terms, we shall not hold their interest. Many of them will not understand, and cannot be expected to understand, what we are trying to say.

The obvious point of all this is that we must think more about the sort of things that management thinks about. We must talk to management in their language and from their viewpoint. Their interest in accounting is largely limited to what accounting can do to meet the problems in their areas.

All this you know, I'm sure—that we must think like management. We must familiarize ourselves with the things of primary concern to management. We need to experience working for them on their side of the fence.

One thing is sure—what we need to do cannot be done all at once. Many business operations are highly complex and the problems are likewise complicated. Time and careful observation and study are required to comprehend them. Without slackening our effort, we must not expect to do it all immediately.

To sum up, the foundation of budgetary control must be based on the business and its problems. Of course, we must know enough

about the techniques of budgeting to be able to visualize their application and usefulness in particular situations. This knowledge will come to life and will attract the interest of the managers of the business only as we ourselves acquire a more intimate understanding of their needs and problems and apply our imagination to their solution.

