

12-1960

Budgets-Types and Purposes

Margaret G. Conley

Follow this and additional works at: <https://egrove.olemiss.edu/wcpa>



Part of the [Accounting Commons](#), and the [Women's Studies Commons](#)

Recommended Citation

Conley, Margaret G. (1960) "Budgets-Types and Purposes," *Woman C.P.A.*: Vol. 23 : Iss. 1 , Article 6.
Available at: <https://egrove.olemiss.edu/wcpa/vol23/iss1/6>

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Woman C.P.A. by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

Budgets—Types and Purposes

By MARGARET G. CONLEY, C.P.A.
International Business Machines
Corporation
Member San Francisco Chapter A.S.W.A.

BUDGETS—A WORKING TOOL

Nineteenth century American business is almost synonymous with the industrial tycoon—the one man show—the individual who combined business genius with a certain lack of scruples to build an industrial empire. But the twentieth century has seen the passing of the species. Government and organized labor have outlawed ruthlessness toward competition and workers; the complexity of modern business transactions has doomed the one man show, except in the very small enterprise. So the new century has produced a new breed—scientific management. With the latter has come a new vocabulary—such terms—as responsibility accounting, management by exception, break-even analysis, operations research, and industrial dynamics—all tools of the trade, some still in the development process. To date the most effective working tool of scientific management is budgetary control. Budgeting is a managerial function; its purpose is to assist management in its three basic areas of planning, coordination, and control. With the exception of its role in securing credit, the budget is for internal use only.

What is the accountant's role in the new management picture? Although the preparation of the budget should be the responsibility of the various operating managers, the successful budget must be based on accurate accounting data. The accountant's contribution is an invaluable one. This is a staff function: to advise, to coordinate, and to review. Here he has an opportunity to reverse his traditional role of working after the fact—converting others' actions into hard cold figures. Through the budgetary process he has access to the inner councils of management, to be a dynamic force in planning a company's long and short range objectives.

A comprehensive budget program is not a simple task, but the rewards are substantial. The fundamental purpose is to ascertain the most profitable plan of action and to hold the business to that plan. Most businesses employing budgetary control find that its most significant benefit is the participation of all levels of management in the planning function. The manager who will be held responsible for the successful execution of the various phases

of the plan contributes to the establishment of goals.

The budget eliminates executive bias and provides a unified and balanced program for all departments. Advance planning tends to reveal weaknesses in the organizational structure; as plans are developed and responsibility delegated, overlapping areas of authority will be discovered. The budget serves as a declaration of basic policy removing the element of uncertainty as to objectives which tends to sap energy and enthusiasm at the lower management levels. Waste is prevented by subjecting all proposed expenditures to thorough investigation. The budget has an important role as an educational tool in executive training. The success of the budget can be measured by the extent to which all executives are aware of the immediate objectives and their part in attaining them.

There are three principal types of budgets. The appropriation budget is common in governmental and institutional budgeting but has a limited use in business. In appropriation budgeting an amount is established as the limit to be spent on a given activity and is formalized by the board of directors through an appropriation. The advertising and research budgets are often appropriation budgets. The fixed or forecast budget involves a plan which is unchanging. Once the objectives are set, they govern all activity for the budgeted period. Their primary usefulness is in the planning and coordination function of management. The variable or flexible budget permits revision of estimates with changes in sales or production volumes. Injecting flexibility into the budget is for control—to determine what costs should be at various levels of activity.

The operating budget is dependent upon basic policy decisions regarding investment and the desired rate of return. Once these basic objectives have been determined, the detailed operating budgets can be prepared.

No place in the budgetary program is the interrelationship of the various budgets more apparent than in the sales budget. Once the profit objective has been determined, the next question is "What volume of sales must be reached to yield the desired profit?" To provide the answer the sales budget must be

prepared in dollar amount. However, the sales forecast is also the backbone of the entire operating budget; upon it will be based the production, materials and inventory, labor, and expense budgets. In these areas dollar sales are meaningless; therefore, the sales budget must also be expressed in physical units by product. In order to efficiently schedule production, maintain satisfactory inventory levels, and aid in cash budgeting, month-to-month sales must be estimated. Orders received should be budgeted as well as shipments.

The sales budget is prepared to serve as a basis for all subsequent operating budgets and for the long-range objective to aid in the planning for capital expenditures.

In essence the sales budget determines what goods can be sold, to whom, at what price, and at what profit margin. It forces management decisions on product planning, pricing policy, selection of distribution channels, choice of sales promotional methods, territorial expansion, and appraisal of competitive conditions.

The production budget is an estimate of the physical units that must be produced to meet the budgeted sales. It is the foundation for the materials and inventory budgets, direct labor, and manufacturing expense. Its purpose is to coordinate all activity toward the most effective utilization of resources. Physical production must be synchronized with sales demand, inventory and plant investment with financial planning, and production costs held to standards. The production budget is normally stated in physical units although in some cases it is necessary to use labor hours, machine hours, or plant operating hours. It includes the distribution of work throughout the budgeted period to assist in production scheduling and labor procurement. In a multi-plant operation, production is budgeted by plant. The objectives of the production budget are not always in harmony: to have sufficient goods to meet sales requirements; to keep inventory within reasonable limits; and to produce the goods as economically as possible. It must reflect the optimum balance between stable inventory and production.

There are two interrelated aspects in materials and inventory budgeting: the acquisition of the necessary goods or the purchases budget, and the maintenance of satisfactory inventory levels or the inventory budget. Materials of the right kind must be delivered on time and in sufficient quantity to serve the needs of production. The purpose of the raw materials budget is to provide quantity data to the purchasing department

so that raw materials purchases can be planned to provide raw material cost figures, to provide information for establishing inventory levels, to determine cash requirements, and to serve as basis for raw materials control.

A major factor in determining profit is the care exercised in inventory control. Excessive inventories result in idle capital; increase the cost of handling, storage, obsolescence, taxes, and insurance; and risk losses due to price declines. Inadequate inventory levels cause unsatisfactory customer service, disadvantage in purchase prices and transportation costs of small quantities, higher internal processing costs of purchase orders, production stoppage for lack of materials, and labor problems from irregular production which could be leveled out by larger inventories. The materials and inventory budgeting program strives for the optimum balance among materials requirements, purchasing, and inventory.

The direct labor budget estimates the direct labor requirements necessary to carry out production. It may specify direct labor cost only, or both hours and costs. The most difficult problem confronting American industry is stability of employment, which in some cases, particularly the food processing industry, is in direct conflict with the nature of the goods produced. In other industries, there is a problem in resolving the conflict between stable production and stable inventory levels. The highest practical degree of regularity of employment can be achieved only through intelligent advance planning. The direct labor budget determines direct labor in terms of hours, number and kind of workers required, and cost. It enables the personnel department to plan recruitment activities, provides data for cash budgeting, and becomes the basis for direct labor control.

The manufacturing expense budget completes the estimated cost of manufactured goods. It includes all items that add to production costs not reflected in the materials and labor budgets. In industries with high plant and equipment investment, manufacturing expense is a significant portion of the total cost. They are particularly suited to the variable or flexible type budget.

The distribution or selling expense budget is developed simultaneously with the sales budget since they interact upon one another. For example, an increase in sales also increases the sales commission expense; conversely, an increase in the advertising expenditure should result in increased sales. All expenses relating to placing the manufactured goods into the hands of the ultimate consumer are included in the selling expense budget. The general or administrative budget reflects all costs not

directly chargeable to selling or manufacturing. Both the selling and administrative expense budgets lend themselves to the flexible budgeting principle.

Two characteristics make the budgeting and control of expenses a difficult task: the variety in the nature and types of expenses and the dispersment throughout the organization of responsibility for incurring these costs. Expenses fall into three general categories—fixed, variable, and semi-variable. Fixed costs are those which remain constant regardless of sales and production volumes and often are recoverable in several budgetary periods. Frequently, they represent long-term commitments outside the responsibility of the operating department involved. Variable costs increase or decrease proportionally with volume and are absorbed in one budgetary period only. They are usually partially controlled by the department charged. Semi-variable costs have some of the qualities of both fixed and variable expenses; they may increase or decrease with volume but not proportionally. Often they are geared to a certain level of activity and then assume a variable nature. Variable costs are usually expressed as a rate per physical unit; semi-variable are stated per unit bracketed by sales or production volume.

Variable expense budgets establish a common denominator for measuring the effects of changes in volume on costs; put the costs of various products on a comparable basis by relating them to plant capacity; give management an opportunity to study costs in their elements of normal capacity, stand-by, and variable; and call attention to the variance between budget volumes and the capacity provided for.

Variable expense budgets also provide the needed information for breakeven analysis, a device bearing a close relationship to budgeting. The familiar breakeven chart plots the fixed and variable costs for relevant levels of activity and determines the sales volume required to produce the desired profit. A more descriptive term is cost-volume-profit analysis, and it reveals the effect on profits of changes in fixed costs, variable costs, sales quantities, sales prices, or product mix. It is an excellent tool for testing various alternatives in budgetary planning.

In a long-range planning program the capital outlay budget is second in importance only to the sales forecast. Failure to anticipate expansion needed to meet customer demand and competition leads to a temporary or even permanent loss of a company's position in its industry. On the other hand, undue optimism results in idle capacity and over investment.

Since it is usually impossible to rectify an error in capital expenditures without sustaining a loss, the plans should be subjected to exacting tests and thorough investigation as to the probability of recovering costs through increased profits. This is the primary function of the capital outlay budget. In general, the budget includes all items not accounted for in the profit and loss statement. The three most common components are plant and equipment additions and replacement, major repairs to existing facilities, and capital research. Specifically, the capital outlay budget should determine the amount which may be safely invested in improved facilities or research; ascertain the increased volume and earnings needed to justify the proposed expansion; provide adequate plant capacity for the sales and production budgets; plan spending for the most advantageous time, provide a basis for financing, restrict expenditures to those authorized; and control costs. For intelligent capital planning, management needs to know the total amount involved, the possible sources of funds, the ultimate gain, and the period of amortization and its effect on future profits.

The basic financial policy of the company must be determined before the operating and capital outlay budgets can be prepared. Management's objective may fall anywhere between the two extremes of restricting planning to available funds with no increase in investment or borrowing, or to secure the working capital required to finance any project promising a satisfactory profit. Once the basic principle is established, the operating and capital outlay budgets can be prepared. They, in turn, serve as the basis for the detailed financial budgets, which are the culmination of budgetary activity. The three main areas are the cash budget, the estimated profit and loss statement, and the estimated balance sheet.

Many businesses prepare a cash budget as the sole output of a planning program. This is not recommended procedure, but does reveal the acute vulnerability of a company's cash position. The failure of many an enterprise can be traced to a lack of foresight in providing adequate working capital to finance current operations. The cash budget is a forecast of the cash position at intervals during the budgeted period. It involves a detailed estimate of the cash receipts and disbursements and is thus dependent on the sales, purchases, labor, expense, and capital outlay budgets. Its broad purpose is to see that the business will have cash when needed and to prevent idle funds. The specific purposes of the cash budget are to provide for seasonal fluctuations which

necessitate heavy working capital to carry large inventories and receivables; to indicate well in advance when additional funds must be secured through short-term borrowing; to serve as a basis for obtaining the needed credit; to assist in having funds available to take advantage of favorable market conditions or cash discounts; to spotlight the dates of maturing obligations such as loan principal or interest payments, taxes, capital additions, and dividend payments; to indicate funds available for investment—the amount, time, and duration of availability. The two prime characteristics of cash requirements are the inflexibility of the time element as regards disbursements and the uncertainty of the receipts due to unexpected variations in cash sales or collections. A margin of safety is mandatory to protect against a cash crisis. The degree to which the industry is subject to wide fluctuations will determine the margin of safety.

The estimated profit and loss statement is prepared after the operating budgets have been completed. Its purpose is twofold: to test the adequacy of the planning as a whole, and to reveal weaknesses in the individual budgets not otherwise apparent. If the expected profit based on the operating plan is unsatisfactory, all or portions of the operating budget may need to be revised. The ultimate goal of budgeting is profit planning. Neglecting to carry the program through to the final operating statement could be a costly oversight. Depending upon the nature of the business, the estimated profit and loss statement may be prepared for each major division, major product, or class of product.

As the estimated profit and loss statement tests the results of planned operations, the estimated balance sheet tests the financial soundness of both the operating and capital outlay budgets. Large profits resulting in an unbalanced financial structure are no more desirable than losses. Statistical data is available for various industries indicating sound operating and financial ratios. Consequently, it is most important that the estimated statements include significant ratios.

The majority of the budgets discussed include the same information now provided in accounting schedules and statements. The difference is in purpose: accounting records the results of operations for a specific period; budgeting predicts results for the future period.

This is the first of a series of three articles based on papers presented at the joint annual meeting of the American Woman's Society of Certified Public Accountants and the American Society of Women Accountants, held in Philadelphia, Pa. September 1960.

(Continued from page 6)

costs. That direct costing, as of today, has not yet been able to provide the multiple purpose tool for cost control and profit reporting as intended, seems of secondary importance in the light of the new overall development. Its primary importance lies in the fact that it focuses attention entirely on the distinction between variable and fixed cost, and it recognizes that costs are not simply a function of either production or sales, but a combination of both.

Alone, this attempt of emphasizing this important interrelationship qualifies Direct Costing as a worthwhile contribution within the frame of dynamic accounting (which is a steady flow of attempts to develop new concepts, assumptions and methods in order to increase accounting and reporting efficiency).

Direct costing also confirms the writer's belief that despite the fact that a new idea or suggestion is actually found unacceptable, its advancing is, in itself, a vital step forward in the direction of truth and perfection. Almost every new idea results out of a desire to overcome weaknesses in conventional tools and theories, and their insufficiencies in coping with the rapidly developing and changing conditions of the economy of our days. Direct Costing has at least forced the cost accounting segment of the accounting profession to thoroughly re-evaluate the conventional methods used in relationship to present usefulness and soundness: It also has convinced the profession that accounting as of today needs multiple purpose tools, capable of dealing with profit reporting as well as with cost and output control in an efficient and stimulating way. Whether the present conventional methods assisted by supplementary devices will be adequate in the future, or whether true multiple purpose tools will be developed to replace them is still an undecided issue.

Seen in the light of all those vital changes in the scope of accounting, Direct Costing seems certainly not a regress, but an organic part of a great new movement of broadened accounting thinking and application. We, as members of this dynamic profession, are better aware of these revolutionary movements and try to understand them, so that we, as authorities like Prof. Moonitz and Prof. Nelson put it,¹³ at least react rationally to the issues that confront us, and are not torn asunder by the demands of expediency or rendered impotent by our own ignorance.

¹³*Op. Cit.*