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# Budgets—Use and Effectiveness

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# Budgets—Use and Effectiveness

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Properly used, budgets can be the most useful and effective working tool at management's disposal. Various companies use budgeting in different degrees. Some prepare only a sales forecast or a budget used primarily to set sales quotas and to establish production planning. Others use budgets for planning, including planning for capital additions, but use no control budget procedures. The full potential of budgeting can best be realized through a comprehensive budgetary program embracing all phases of operations and utilized for planning, coordination and control purposes.

After the budget has been compiled, revised with the agreement of the supervisor in charge of that section, and approved by the president or board of directors of the company, the appropriate copies are distributed to the department heads and top level supervisors. The question now arises as to how the plan should be put into effect. Should the budget be a rigid one, or should it fluctuate with the changes of conditions? Should it be used as a pressure device?

To be most effective and to obtain the best cooperation of all concerned, it should be a dynamic budget that will reflect all major changes in conditions and policy but should not be revised indiscriminately. All major changes should have not only the approval of the budget supervisor but of the head of the company—either the president or board of directors, inasmuch as they are responsible for the profit position of the company.

The budget should not be used as a weight over the head of the supervisors but should incorporate attainable goals and objectives, and at the same time present a challenge.

After the budget is distributed, the president should discuss budget utilization with the top executives, emphasizing the necessity for actively putting the budget into effect, and the importance of continuous control through follow up. This conference should be followed by similar conferences called by division heads of lower supervisory levels, and the procedure continued on downward through all levels of supervision until all those responsible for any part of the plan shall be thoroughly briefed on the details of the budget and as to exactly what is expected of each person to bring about a favorable comparison to budget of actual results. This procedure will induce the necessary budget consciousness throughout management, and, if followed properly, insure its active support.

The budget program provides the supervisor of each major subdivision of the firm with a concrete basis for detailed operating plans for his department. On this basis, the purchasing department can proceed to place orders for raw materials at an early enough date and in quantities of sufficient size to obtain favorable prices, a major factor in reducing costs. The treasurer can make plans for necessary financing or arrange an investment plan for idle cash as it becomes available. Similarly, other supervisors can plan the production, with sufficient time to make a calculated, well thought-out program.

Nevertheless, top management must realize that the budget, no matter how well designed and how carefully drawn, cannot manage. Men, not budgets, perform the management function. Therefore there must be constant managerial effort and attention. There must be a constant inspection of an overall picture of the effort and its effect on profits with revisions in the budget control when it is weak or not giving the proper profit results.

Many companies make a careful study of the planning budget at the beginning of each quarter to determine whether or not the budget should be revised. Often minor revisions are not made to the budget and the effect will appear in the budget reports as an explainable variation. Where major changes in conditions have occurred, such as rearrangement of internal organizational structure, changes in manufacturing methods, strikes, changes in salary rates, etc., it may be necessary to revise the budget completely.

Enforcement of the budget by all levels of management necessitates an effective communication and reporting system that quickly and accurately indicates either success or failure as measured in terms of budget objectives. Reports must be designed to expose unfavorable situations needing immediate managerial action in order that correction can be made when it will be effective.

In larger companies, management must rely upon information contained in reports developed within the concern, because management cannot easily observe, analyze and assemble all facts relative to the operations.

As stated in "Presenting Accounting Information to Management" NACA Bulletin, Research Series No. 28 December 1954:[1]

[1]"Presenting Accounting Information to Management," NACA Bulletin, Research Series No. 28, December 1954.

"In order to be useful to management, accounting information must be communicated to management personnel. Communication implies that a person receiving the information understands the nature and significance of material contained in the reports he receives. When communication is genuinely effective, management's actions and decisions are likely to be based on facts which they receive rather than on untested impressions and guesses. However, there is reason to believe that accounting reports to management have not always achieved their intended purpose because the reports were not understood, recipients lacked time required to grasp the meaning, or the content of reports was not relevant to problems facing the person who received them."

Reports that communicate effectively to all levels of management stimulate action and influence decisions. To communicate effectively, reports should not include superfluous information which only clutters the report and causes it to appear too voluminous. A short concise report that effectively focuses on the vital information, particularly aimed at the person responsible for its control, will receive the attention it requires and bring about the desired action. An overlong, overdetailed report including much information of no interest to the person receiving it will not be read and the section prepared for his department will not be noticed. Most accounting and budget reports contain too much information rather than too little.

As presented by Glenn Welsch in "Budgeting" [2] reports should:

(1) Be consistent with the organization structure.
(2) Utilize the principle of exception where possible.
(3) Be simple and understandable.
(4) Contain only essential information.
(5) Be adapted to the personality of the user.
(6) Be designed with consideration of the use to which they will be put.
(7) Be accurate.
(8) Be prepared and presented promptly.
(9) Convey a tone of helpfulness rather than criticism when possible.
(10) Be standardized where possible.
(11) Include a basis for evaluation of the data.

Basically there are two types of financial reports that should be presented to management. First, the periodic report of results for a specific period of time—a week, month, or year. This is prepared on the supervisory division basis and includes only the information of interest to that division with overall summaries for top management.

In addition, there are the special or project reports concerned with special or nonrecurring circumstances.

To use effectively the "principle of exception," (the second point on the list of "musts" of a report per Mr. Welsch) a report should be simple with descriptive, usually nontechnical headings. The sources of trouble where results are under budget (the exceptions) should be prominently marked with an explanation of the variance, if it is an explainable variance. With the inclusion of the detailed reports of the lesser divisions with the summary reports, top management can trace this variance to its source in a certain department and to a certain process. Corrective measures can then be proposed.

Adapting the report to the personality of its user, is an important consideration, frequently overlooked. Executives who will utilize the reports have different backgrounds, working methods, personalities and personal preferences. Executives with controllership background prefer tabulated and detailed presentations, those with engineering backgrounds prefer graphic presentations, and those with sales backgrounds are just not interested in reports. The accountant has his work cut out for him to satisfy the latter.

In an article entitled "Management Looks at Budgeting and Planning" by John I. Snyder, Jr., President of the Board, U.S. Industries, Inc., in the September 1958 issue of "Business Budgeting" [3] shows how uncertain the executive himself may be as to what he wants in a report.

"Perhaps you are going to accuse me and my fellow executives of not knowing what we want. Why can't we articulate and give you exact specifications on how budget material should be presented? My answer is that planning is not routine enough, moves too quickly, to fit a set formula. The emphasis can shift all over the map."

He leaves us with—"In a sense, middle management must keep pace, however limpingly, with the lessons learned by top management as it struggles through the wilderness of business change. The budgeteer, therefore, can never freeze a given design of presentation without courting slights and rebuffs."

Often a graph will present the desired information much more clearly than a list of figures, and where clarity is improved, this type of presentation should be used.

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[2] Glenn A. Welsch: "Budgeting-Profit-Planning and Control," 1957, Prentice Hall, Inc.

[3] John I. Snyder, Jr. and Marshall Hoyt: "Management Looks at Budgeting and Planning," Business Budgeting, September 1958.

Timeliness is the watchword of budget reporting. Is it being presented to management at a time when the information will be usable, or is it so late that nothing can be done to correct unfavorable trends? Timeliness is generally more important than a high degree of accuracy. Most accountants delay reports until they are sure the "facts" are known. Since accounting data can seldom be exact, those preparing reports should not hesitate to make reasonable estimates of items not known exactly, so that an early report is possible. Reports should be issued by the fifth or seventh day of the following month even if items are estimated. The slight difference in accuracy will not impair the effectiveness of the resulting data for managerial purposes, and, being budget reports, will be for internal use only.

Where certain types of variations are shown, further analysis of these variations can be completed when the information is available and the resulting analysis is of use to management. Such analyses may provide management a better insight into the underlying causes of the variation and permit the corrective action to be taken.

In the case of an unfavorable variation in sales, the supporting schedule will show which product is under budget but the analysis may show that the variation is not due solely to a drop in the number of items sold but is the result of a drop in number of items or "quantity factor" compensated by an increase in price per item which produced an increase in income for the number of items sold or "price factor." The difference between the two is the actual variance. With this information, management may decide the increase in price was a mistake resulting in fewer sales and may act accordingly. Such analysis gives management the underlying information needed to make decisions.

This same type of analysis is used for the overall study of budget variations in net profits which could be the result of changes in sales price, quantity mix, sales mix, cost price of goods sold, or other factors. Analysis must be made to ascertain where the trouble lies. In some instances presenting a report showing over and under budget is not sufficient data for intelligent decision.

A technique used by many companies in connection with their budget programs, is the cost-volume-profit analysis or the breakeven analysis. This technique is most useful to future estimates. However, unless all costs can be accurately segregated as to fixed or variable, this analysis cannot be used. Many leading companies have demonstrated that such determination is not only possible, but that it can be done with reasonable accuracy.

Breakeven analysis is concerned with the effect on profits of (a) changes in fixed costs, (b) changes in variable costs, (c) changes in sales quantities, (d) changes in sales price, and (e) changes in sales mix.

The method used is the plotting on a graph of changes in total costs (fixed plus variable) as one line and changes in sales revenue as the other line with volume as the horizontal scale and dollars of revenue or costs the vertical scale.

Since fixed costs will stay relatively constant no matter what the volume of sales, and variable costs vary with sales, there is a point (the breakeven point), where the revenue from sales, if large enough, will cover fixed plus variable costs. From that point on, additional sales will result in a profit due to the gap between variable costs and revenue no longer needed to cover fiixed costs. On the graph the total cost line and sales revenue lines cross at the breakeven point and the area beyond that intersection is the profit potential.

Through variation of cost price, sales price, sales quantities and sales mix, this point of intersection will vary and will show graphically the results of such decisions before they are committed to use, thus saving many unpleasant surprises to management.

If the company, in analysing its cost-volume-profit position, finds it is nearing the breakeven point, this will indicate it is time to change policies or profits will disappear. Therefore, management is warned before the danger point is reached and can correct the situation in time.

The final step in all this procedure is the managerial follow-up. Unless management acts to correct deficiencies, all the efforts up to this point have been wasted. Some concerns favor formal explanations of unfavorable variances. Others feel a more constructive approach should be used. In some cases constructive conferences are held starting at the top with the budget committee and working down through the ranks where such conferences are needed. Through discussion of both satisfactory and unsatisfactory results, decisions as to ways and means of cerrecting unsatisfactory conditions can be made most intelligently. It should be noted that the follow-up procedure is strictly a line function rather than a staff function. The budget director, controller, or other staff officer should not undertake, or be assigned, the responsibility for "enforcing the budget."

In conclusion—for a budget to be useful and effective it must:

(1) Have the support of top management.
(2) Be based on the line of formal organization of the company.

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# Comment and Idea Exchange

By Marion Davis

## A STEP IN THE RIGHT DIRECTION

The joint purpose of the American Woman's Society of Certified Public Accountants and the American Society of Women Accountants is sometimes tersely stated as "the advancement of the interests of women in accounting." An excerpt from a letter from Kathryn M. Iliff, an accounting instructor at Northern Illinois State Teachers College, illustrates progress in implementing that dual purpose:

"I am undertaking a research project here at Northern which will involve interviewing certified public accountants in this area—for the purpose of exploring opportunities for women in this field, current attitudes toward the employment of women accountants, work assignments of the woman accountant, guidance and placement of women accounting majors, and qualities which contribute to the success of the woman accountant.

"My interest in this topic has developed as a result of contact with your organization and with the highly qualified women students I now have who have difficulty in securing internships or suitable accounting positions upon completion of the degree. I feel that it is one of my obligations to help guide and encourage these gifted young women to continue their efforts toward the goals which they seek. And the American Society of Women Accountants has made my task much easier. Both faculty members and students are amazed at the number of women who have accomplished so much in this field."

Kathryn Iliff is a member of the Rockford Chapter of the American Society of Women Accountants.

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## TAX FREE INCOME FROM EXCESS FUNDS

Accountants, whether in private industry or in public practice, should be on the alert to perform an additional service for employers or clients by periodically reviewing cash positions and recommending investment of any excess cash.

Of particular advantage is the investment of the excess cash in triple A bonds of cities or states, a source of tax-free interest income. These gilt-edge securities carry the smallest degree of risk, and can be used as loan collateral with borrowings frequently allowed up to 80% or 90% of their face value.

Audra Ferrey, Los Angeles Chapter

## INTERNATIONAL ACCOUNTANTS SOCIETY GOOD FRIEND OF AWSCPA-ASWA

This issue begins a sixteenth year of very pleasant association by The Woman C.P.A. with the International Accountants Society, which has consistently advertised in our publication since June, 1946. Periodically the IAS has brought our publication to the attention of its women students. Their most recent subscription campaign, now being concluded, has brought us approximately nine hundred new readers.

We welcome these new subscribers and hope they find in our publication a source of inspiration to complete their accounting studies. Many of these accounting students have subsequently become affiliated with one of our ASWA chapters, which now number 74.

We recognize the contribution which Mr. E. McDonald, President of the International Accountants Society continues to make to assist carrying out the purpose of the American Society of Women Accountants "to advance the interest of women in all fields of accounting."

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## POINTS TO PONDER FROM PREVIOUS ISSUES

" . . . 'The demonstrated ability to get the job done' . . . is the woman accountant's secret weapon for completely disarming the opposition."—August, 1960.

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(Continued from page 9)

(3) Be carefully and accurately compiled on the basic accounting set up of the company.

(4) Must be accompanied by continuous budget education throughout the company.

(5) Result in clear, concise and usable reports.

(6) Be used as a basis of carefully considered action on the part of management to correct the profit position.

A budget is not a panacea but a management working tool and a means to an end—the dream of all business—greater profits.

*This is the final article of a series of three, 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.*