

STRATEGIC MANAGEMENT ACCOUNTING

SMA

LECTURE 4_1

ASPECTS ON BUDGETING

PRESENTATION OUTLINE

A) INTRODUCTION

B) PLANNING: SHORT AND LONG TERM

C) STAGES IN THE PLANNING PROCESS

D) BUDGETING

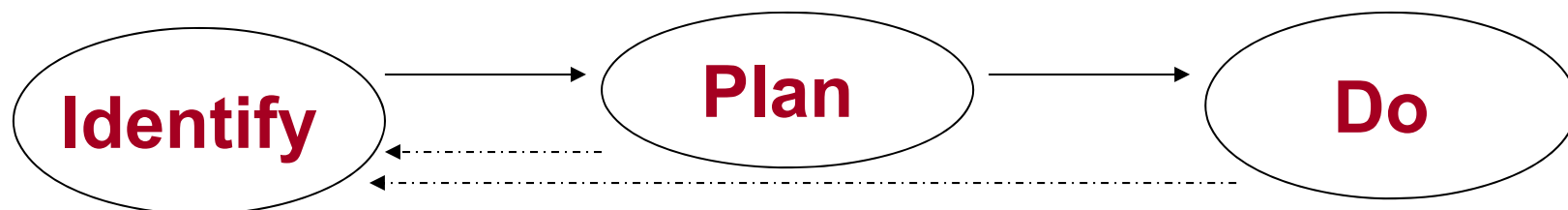
E) THE MULTIPLE FUNCTIONS OF BUDGETS

F) BUDGETING STRATEGIES

G) CRITICISMS OF BUDGETING

A) INTRODUCTION

(Strategic) Management accounting provides data and information to assist managers in decision-making. To decide means to identify, plan and undertake actions, which involve several aspects of business, in order to meet the **established objectives**. These initiatives within a company should be coordinated by the preparation of plans for future periods.



B) PLANNING: SHORT AND LONG TERM

Planning is the process through which managers **design/identify** the desired future and of effective way of bringing it about.

Short-term planning

It must accept the environment of today, and the physical, human and financial resources at present available to the firm.

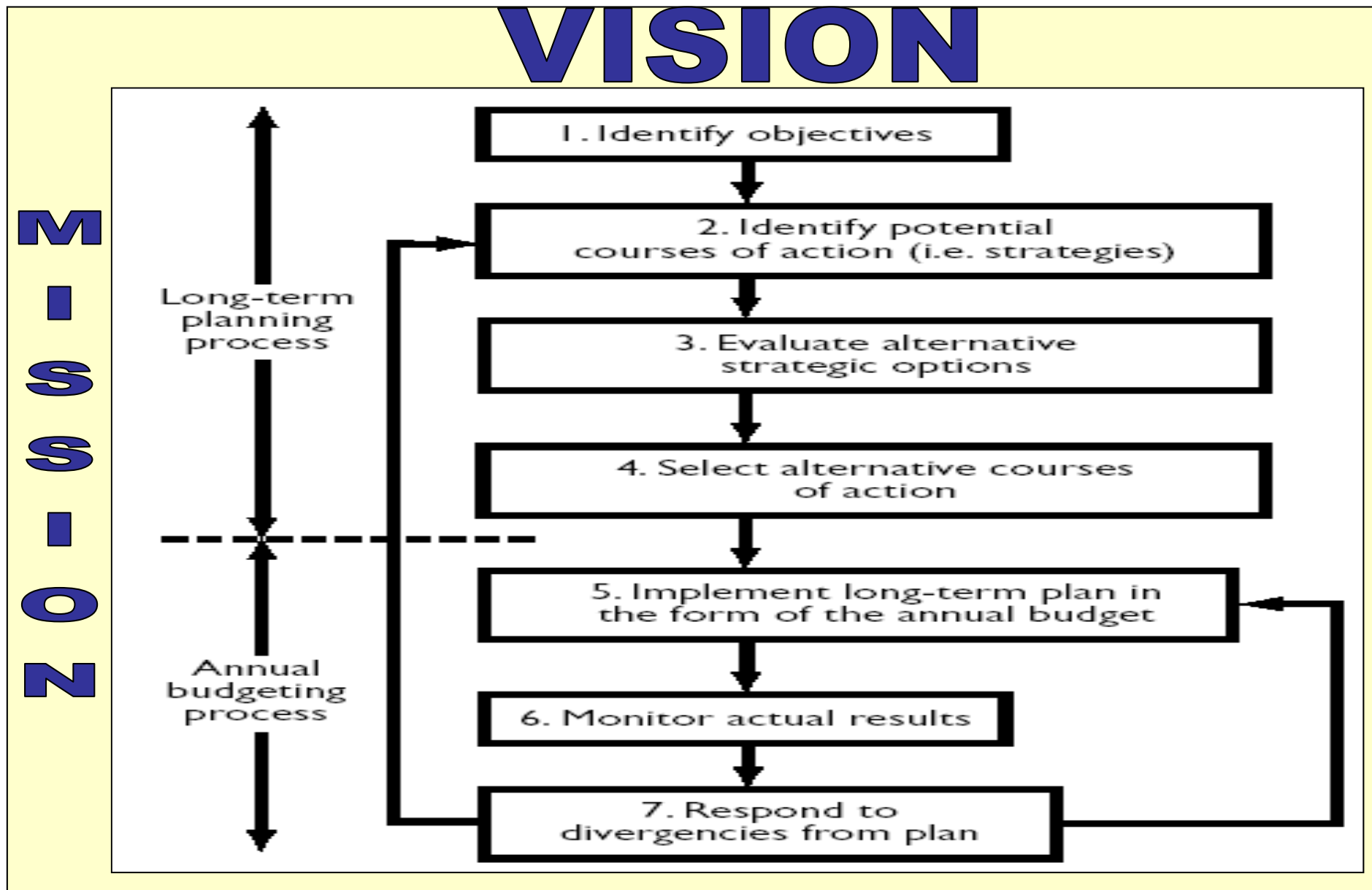
It is called budgeting

Long-range planning

It is defined as a systematic and formalized process for directing and controlling future operations towards desired objectives for periods extending beyond on year.

It is called strategic or corporate planning.

C) STAGES IN THE PLANNING PROCESS



C) STAGES IN THE PLANNING PROCESS

The analysis of the stages in the planning process is useful to understand the budgetary process.

- 1) establishing objectives;**
- 2) identify potential strategies;**
- 3) Evaluation of strategic options;**
- 4) Select course of action**
- 5) Implementation of the long-term plans;**
- 6) Monitor actual results;**
- 7) Respond to divergences from plan**

C) STAGES IN THE PLANNING PROCESS

1) ESTABLISH «DESIRED» OBJECTIVES

They represent the objectives that the organization is trying to achieve and towards which future operations should be directed. For example:

- 1) Corporate objectives: relate to the organization as a whole. They are expressed in financial terms such as desired profits or sales levels;
- 2) Unit objectives: relate to the specific objectives of individual units within the organization, such as a division or one company within a holding company

2) IDENTIFY STRATEGIES

Possible courseS of actions are identified in order to achieve company's objectives. The process of identification of strategies implies:

- 1) SWOT analysis: it is a strategic analysis;
- 2) Formulation of generic strategies: i) cost leadership; ii) differentiation; iii) focus;
- 3) Identification of the directions to undertake

C) STAGES IN THE PLANNING PROCESS

3) EVALUATION OF STRATEGIC POSITIONS

The alternative strategic positions should be examined & compared considering the following criteria: i) suitability; ii) feasibility; iii) acceptability.

4) SELECT COURSE OF ACTION

Long-term plans should be established to implement strategies. **A long-term plan** is a statement of the preliminary targets and activities required by an organization to achieve its strategic plans together with a broad estimate for each year of the resources required

C) STAGES IN THE PLANNING PROCESS

5) IMPLEMENTATION OF THE LONG-TERM PLANS

The budgeting is concerned with the implementation of the long-term plan for the year ahead. **BDGs are more precise and detailed.** They are a clear indication of what is expected to be achieved during the BDG period whereas long-term plans represent the broad direction that top management intend to follow

6) MONITOR ACTUAL RESULTS

Actual results are compared with the planned outcomes

7) RESPOND TO DIVERGENCES FROM PLAN

Initiatives are undertaken to respond to divergences from planned outcomes

D) BUDGETING

- **Budgets are concerned with the implementation of the long-term plan**
 - Shorter planning horizon implies that budgets are more precise and detailed
 - Give a clear indication of what is expected to be achieved during the budget period
- **Budgets do not originate 'from nothing' each year**
 - Developed within the context of ongoing business
 - Ruled by previous decisions that have been taken within the long-term planning process.
- **Budgeting as an ongoing process:**
 - Must be reviewed and revised in the light of more recent information
 - Part of the annual budgeting process
 - Results in decisions taken on possible activity adjustments within the current budget period.
- The budgeting process it must be considered as an integrated part of the long-term planning process.

E) THE MULTIPLE FUNCTIONS OF BUDGETS

- Budgets serve a number of useful purposes:
 - **P: planning** annual operations;
 - **C: coordinating** the activities of the various parts & functions of the organization and ensuring that are in harmony with each other;
 - **CM: communicating** plans to the various responsibility centre managers;
 - **M: motivating** managers to strive to achieve the organizational goals;
 - **CR: controlling** activities;
 - **E: evaluating** the performance of managers.

E) THE MULTIPLE FUNCTIONS OF BUDGETS

1) PLANNING

- The annual budgeting process leads to the refinement of the long-term plans and helps managers to plan for future operations
- The budgeting process
 - ensures that managers do plan for future operations
 - that they consider how conditions in the next year might change what steps they should take to respond to changed conditions
 - encourages managers to anticipate problems before they arise

E) THE MULTIPLE FUNCTIONS OF BUDGETS

2) COORDINATION

- The budget serves as a vehicle to bring together and reconcile into a common plan the different parts of an organization.
- Managers need to make decisions considering other parts of business. For example:
 - the purchasing manager may prefer to place large orders so as to obtain large discounts;
 - the production manager will be concerned with avoiding high stock levels;
 - the accountant will be concerned with the impact of the decision on the cash resources of the business.
- The aim of budgeting is to reconcile these differences for the overall benefit of the organization as a whole

E) THE MULTIPLE FUNCTIONS OF BUDGETS

3) COMMUNICATION

- To function effectively, there must be clear lines of communication within the organisation
- All involved parts need to be fully informed of the plans and the policies, and constraints
- Everyone should have clear understanding of the part they are expected to play in achieving the annual budget
- The budgeting process ensures that appropriate individuals are made accountable for implementing the budget
- It is not just the budget itself that facilitates communication - much vital information is communicated in the actual act of preparing it

E) THE MULTIPLE FUNCTIONS OF BUDGETS

4) MOTIVATION

- The budget:
 - can be a useful device for influencing managerial behaviour and motivate managers
 - provides a standard that the manager may be motivated to strive to achieve
 - but can also encourage inefficiency and conflict between managers
- Active participation in preparing the budget implies that budgets can act as a strong motivational device by providing a challenge. Alternatively, when the budget is dictated from above it may be resisted and do more harm than good

E) THE MULTIPLE FUNCTIONS OF BUDGETS

5) CONTROL

- Budgets assists managers to manage and control the activities they are responsible for;
- By comparing the actual results with the budgeted amounts managers can see which costs do not conform to the original plan;
- This enables managers to operate a system of **management by exception**, i.e. that a manager's attention and effort can be concentrated on deviations from expected results;
- By investigating the reasons for the deviations, managers can to identify inefficiencies such as the purchase of inferior quality materials
- With the reasons for inefficiencies identified, appropriate control action can be taken to remedy the situation.

E) THE MULTIPLE FUNCTIONS OF BUDGETS

6) PERFORMANCE EVALUATION

- Budgets are used to
 - Evaluate manager's performance by measuring the success in meeting the budgets
 - Bonuses are often awarded on the basis of the ability to achieve the targets specified in the periodic budgets
 - Promotion may be dependent upon a manager's budget record
 - In addition, the manager may wish to evaluate his or her own performance
- Budget provide a useful means of informing managers of how well they are performing in meeting targets that they have previously helped to set.
- The use of budgets as a method of performance evaluation also influences human behaviour

CONFLICTING ROLES OF BUDGETS

- Risk of conflicting purposes within a single budget system, e.g. planning and motivation
 - Demanding budgets that may not be achieved may be appropriate to motivate maximum performance, but they are unsuitable for planning purposes.
- There is also a conflict between the planning and performance evaluation roles
 - For planning purposes budgets are set in advance of the budget period based on an anticipated set of circumstances or environment
 - Performance evaluation should be based on a comparison of actual performance with an adjusted budget to reflect the circumstances under which managers actually operated

F) BUDGETING APPROCHES

- **Incremental budgeting** – perhaps the most popular
 - Based upon the budget set for the previous period plus (or minus) some adjustment for changing prices or anticipated changes in activity.
- **Zero-based budgeting**
 - Projected expenditure for existing programmes should start from base zero
 - Requires that all activities are justified and prioritised before decision are taken
 - Top-down approach
 - Can be threatening and time consuming
 - Its advantage is that it forces each department to review its activities, set goals and justify its claim on resources on a regular basis

F) BUDGET STRATEGIES

- **Programme-based budgeting**
 - Conducted through programmes e.g. for products, projects or campaigns
- **Market test budgeting**
 - Service departments are required to bid for a continuation of its activities in competition with external suppliers.
 - May generate considerable anxiety amongst staff
- **Life cycle budgeting**
 - Cost and revenue flows over a whole product life cycle are projected and placed into a life cycle budgetary plan.
 - Problematic in multi-product firms who have a number of life cycles in operation, all of different durations and terminations
- **Activity based budgeting**
 - The aim is to authorise the supply of only those resources that are needed to perform activities required to meet the budgeted production and sales volume

G) CRITICISM OF BUDGETING

Human Relations Studies of Budgeting

- The human relations critique got off the ground in the 1930s when a study by the National Industrial Conference Board (US) indicated that imposed budgets might be causing just as much harm as they were doing good
- A survey of managers and supervisors indicated a good deal of dissatisfaction with **top-down budgets**
- Recommended that department managers should prepare budgets initially and then submit them to managers for editing
- The idea was that participation in budgeting could remedy some of the dissatisfaction with budgets – that is, the bottom-up approach to budgeting.... (see studies)

G) CRITICISM OF BUDGETING

- Hopwood (1974) introduced the idea that the way the accounting system is used when appraising performance can have a profound impact on job-related behaviour. He identified three distinct styles:
 - non-accounting – superiors are indifferent to budgetary performance information or are unaware of its intended purposes. Accounting information plays a relatively unimportant role in evaluating the performance of their subordinates.
 - profit-conscious – superiors treat the budget not as an end in itself but as a means to increase the general effectiveness of operations dictated by long-term goals and programs.
 - budget-constrained – Still other superiors rely on the budget-constrained style, the one of most interest to us here

G) CRITICISM OF BUDGETING

- Mirrors the way budgets were used by factory executives and budget officers in the Argyris's (1952) study.
 - subordinates' performance evaluated primarily on the basis of whether or not they meet the short-term targets in the accounting reports
 - information is used in an unquestioning and overzealous manner
 - subordinates are blamed for unmet budget targets, cost overruns, and sales and profits shortfalls
- Not surprisingly, budget-constrained subordinates find their superior's evaluations of their performance to be unjust and improper
- Subordinates working under the budget-constrained evaluation style respond with a host of negative and dysfunctional activities.
- They dislike financial controls and are not indisposed to manipulate them.
- When subordinates participate actively in budgeting, however, the negative effects of the budget-constrained style tend to decrease.