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## Budgeting For Profit In Management Planning

Jack M. Curtis

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BUDGETING FOR PROFIT IN MANAGEMENT PLANNING

by

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An Independent Study

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of the

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This independent study submitted by Jack M. Curtis in partial fulfillment of the requirements for the Degree of Master of Science in the University of North Dakota is hereby approved by the Committee under whom the work has been done.

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## TABLE OF CONTENTS

	PAGE
ABSTRACT.....	iv
INTRODUCTION.....	1
Chapter	
I.    HISTORY OF BUDGETING.....	3
II.   TYPES OF BUDGETS.....	5
III.  THE OBJECTIVES OF BUDGETING.....	10
IV.  BASIC CONSIDERATIONS IN BUDGETING.....	21
V.   CONCLUSION.....	29
VI.  RECOMMENDATIONS.....	31
BIBLIOGRAPHY.....	33

## ABSTRACT

The managerial task of performing the requisite planning, organizing, and control of the various activities of an enterprise to meet the desired objectives has become increasingly difficult. This study explores the application and use of the business budget to assist management in this difficult task. The study seeks to isolate the basic considerations in planning, executing, and control in the budgeting process which must be considered if budgeting is to provide management with an effective tool to assist in profit planning and control.

This study reviews the demands and requirements of the management functions of planning, coordinating, and control. It then seeks to establish the contributions and assistance budgeting can provide management in the accomplishment of these functions. Then to insure that management is realizing the full potential of this valuable tool the basic considerations are reviewed.

While concluding that the budget is of significant value as a tool to assist management in accomplishing the desired objectives, the study indicates that the benefits derived reflect the care and effort the budgeting program receives. The potential of this valuable tool is in direct relationship to the application of the basic considerations.

## INTRODUCTION

The progressive business enterprise of today does not usually or for long achieve its objective by mere chance. A necessary ingredient is management. The managerial task is to perform the requisite planning, organizing, and controlling of the activities of the subordinate groups of the enterprise to the end that the business objective is attained. Management must constantly search out the needs and desires of the customers. It must direct and coordinate the research, production, distribution, and financial functions so that they are effectively and efficiently performed.

The changing currents in our economic and social life make this task increasingly difficult. It is no longer simply a matter of good intentions. Today the need is for a high degree of managerial skill and intelligence to carry out the appointed tasks. These skills imply or require a thorough knowledge of the basic elements of the business and familiarity with modern management techniques.

The increasing complexity of managerial problems has led to the development of certain managerial approaches, tools, techniques, and procedures generally referred to as "scientific-management". One of the important developments in this area is business budgeting or the more positive phrase "profit planning". To keep pace with the

competition, management has found it must chart its course in advance and must use appropriate techniques to assure control and coordination of operations. Following this approach, the attainment of managerial goals is more likely. Scientific management has come to recognize business budgeting as one of the more effective managerial tools or techniques.

The mere existence of a budget within an organization does not in itself insure that management is realizing the full potential of this instrument to assist in the management functions. To be an effective managerial tool there are certain basic considerations in planning, executing and control which must be considered. The purpose of this report is to isolate these basic considerations and to provide a better understanding of the potential value of budgeting as a tool of management in the business organization.

## CHAPTER I

### HISTORY OF BUDGETING

The word "budget" comes from the French word "bougette," meaning bag.<sup>1</sup> The Chancellor of the Exchequer in England carried his estimate of the tax needs in a leather bag. This estimate became known as a "budget."

The use of budgets as a means for the allocation and control of expenditures dates back to the eighteenth century.<sup>2</sup> Income from taxation was relatively fixed at this time and on the basis of the anticipated income budgets of expenses were authorized for the various governmental divisions. The early budgets served as instruments for control of expenditures for the designated periods of operation. Institutions such as churches, hospitals, and private schools adopted a similar budgeting practice.

In this country budgets first appeared in city administrations in about the year 1912 and The Bureau of the Budget established a

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<sup>1</sup>Henry G. Hodges, Management (Boston: Houghton Mifflin Co., 1956), p. 199.

<sup>2</sup>Lawrence L. Bethel et al., Essentials of Industrial Management (2d ed. rev.; New York: McGraw-Hill Book Co., Inc., 1959), p. 416.



national budget in 1922.<sup>1</sup> In this latter year James O. McKinsey created an interest in business use of the budget in his book Budgetary Control. This was one of the first attempts to treat the subject as a whole and to recommend general business use of the budget.<sup>2</sup>

Budgeting for the industrial enterprise developed as a part of the "scientific-management" movement of the past quarter of a century.<sup>3</sup> This early use of the budget in industry was limited to a means for the systematic authorization of such expenses as advertising, supplies, and maintenance. The more extensive use of budgets to include sales and production operations came with the movement toward a more systematic analysis and control of production operations and costs.

By 1929 the use of the budget was well established in industry. However budgeting as an effective tool for planning belonged to only a few pioneering companies such as DuPont and General Motors.<sup>4</sup> Only after World War II, with the post war emphasis on profits, did budgeting receive wide acceptance for both planning and control.

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<sup>1</sup>Paul R. Cone, "The Budget as an Instrument of Managerial Planning and Control." (Unpublished Doctor's dissertation, Dept. of Business Administration, University of California, 1964), p. 222.

<sup>2</sup>Neil W. Chamberlain, The Firm: Micro-Economic Planning and Action (New York: McGraw-Hill Book Co., 1962), p. 25.

<sup>3</sup>Glenn A. Welsch, Budgeting: Profit Planning and Control (2d ed. rev.; Englewood Cliffs, New Jersey: Prentice Hall, 1964), p. 3.

<sup>4</sup>"Business Budgets - to each his own," Business Week, May 30, 1964, p. 76.

business budget still, but plans for revenues and costs.

## CHAPTER II

### TYPES OF BUDGETS

Since the sales department is the center of the business,

To be an effective tool for management the budget must be well coordinated. It should be a single, unified plan.

express the plans and objectives of the entire organization. Since the owner-manager of a small business usually has a clear, definite plan,

typical enterprise has a large variety of plans and objectives, there are many types of budgets. One author finds that the average manu-

facturing company requires twenty-eight major types of budgets to have a complete budgetary system.<sup>1</sup> Koontz and O'Donnell have classified

budgets into five basic types with a budget summary portraying the total planning picture of all the budgets.<sup>2</sup> These five basic types are:

(1) revenue and expense budgets, (2) time, space, material, and product budgets, (3) capital expenditure budgets, (4) cash budgets, and (5) bal-

ance sheet budgets. Hodges prefers to classify budgets in regard to the different ways they can be used.<sup>3</sup> This includes (1) fixed, (2) semi-

fixed, (3) variable, and (4) flexible or continuous. Regardless of classification the following discussion includes the basic types of budgets in use today.

Time, Space, Material, and Product Budgets

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Time, Space, Material, and Product Budgets

Time, Space, Material, and Product Budgets

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<sup>1</sup>J. K. Lasser et al., Executive Course in Profitable Business Management (New York: McGraw-Hill Book Co., 1952), p. 553.

<sup>2</sup>Harold Koontz and Cyril O'Donnell, Principles of Management (3d ed. rev.; New York: McGraw-Hill Book Co., 1964), p. 548.

<sup>3</sup>Hodges, 207.

Revenue and Expense Budgets. --By far the most common business budgets spell out plans for revenues and operating expenses in dollar terms. The most basic of these is the sales budget. The sales budget is the formal and detailed expression of the sales forecast. Since the sales forecast is the cornerstone of planning, the sales budget is the foundation of budgetary control. Although a company may budget other revenues, such as expected income from rentals, royalties, or miscellaneous sources, the revenue from sales of products or services furnishes the principle income to support operating expenses and yield profits. The operating budgets of the typical business can be as numerous as the expense classifications in its chart of accounts and the units of organization in its structure. These budgets may deal with individual items of expense, such as direct labor, materials, and many others. The firm may choose to budget major items and lump together other items in one control summary.

Time, Space, Material, and Product Budgets. --Many of the budgets are better expressed in physical rather than monetary terms. Although such budgets are usually translated into monetary quantities, they are much more significant at a certain stage in planning and control if dealt with in physical quantities. Among the more common of these budgets are those for direct-labor-hours, machine-hours, units of materials, and units produced. Most firms budget product output, and most production departments budget their share of the output of components of the final product. It is also common to budget manpower

in labor-hours or man-days with consideration of the manpower required. There are budgets which cannot be well expressed in monetary terms for the dollar cost would not accurately measure the resources used or the results intended.

Capital Expenditure Budgets. -- This budget outlines capital expenditure for plant, machinery, equipment, inventories, and other such items. Whether for a short or a long term, these budgets require unusual skill in giving definite form to plans for spending the funds of the enterprise. Capital resources are generally one of the most limiting factors of the business; and, since investment in plant and equipment usually requires a long period for its recovery from operations, the importance of the capital expenditure budget cannot be over-emphasized. The capital expenditure budgets require difficult long-term planning and are of major importance to the future of the enterprise.

Cash Budgets. -- The cash budget is a forecast of cash receipts and disbursements against which actual cash experience is measured. The availability of cash to meet obligations as they fall due is the first requirement of business existence. Handsome profits are of little immediate value when tied up in inventory, machinery, or other non-cash assets. Cash budgeting also will indicate the probable availability of excess cash. This makes possible planning for profit-making investment of this cash.

Balance Sheet Budgets. -- The balance sheet budget forecasts the status of assets, liabilities, and capital account as of particular times in the future. Since the sources of change in balance sheet items are the various other budgets, this budget proves the accuracy of all other budgets. In addition to the balance sheet budget, which forecasts the status of the business as a whole, there are many items of the balance sheet which may be budgeted in varying degrees of detail. The more common, in addition to cash and capital investments, are special budgets of accounts receivable, inventories, and accounts payable.

Budget Summaries. -- The complete balance sheet budgets are a form of budget summary. In addition, a master budget gathers together all the budgets for the several departments of a business and summarizes them, first in a forecast income statement, and then in a forecast balance sheet. The former may be in detail or it may be in summary form, showing only the principal items of revenue, expense, loss, and profit.

### Variable Budgets

Industry inherited the static budget or fixed budget from governmental and institutional organizations. The static budget served a valuable purpose in the planning and control of certain fixed expenditures, but the inadequacies of such a budget were soon discovered. When industry moved into the period of mass production, where margins

of profit per unit of production were small, the planning and control of the over-all operations became more essential. It soon became evident that cost per unit changes at different levels of production, and the degree of change varies on different products and even on different operations involved in the manufacture of the same product. For the budget to continue to be an effective tool for management a new approach to budgeting became a necessity.

The dangers arising from inflexibility in the static budget led to the development and use of the variable or flexible budget. Since maximum flexibility consistent with efficiency underlies good planning, attention has been increasingly given to the variable budget. The variable budget is designed to vary as the volume of sales or production varies. It provides in advance for orderly change in the volume of production and in expenditures.

### CHAPTER III

#### THE OBJECTIVES OF BUDGETING

Some authors prefer to distinguish between the two terms "budget" and "budgeting." Glenn A. Welsch<sup>1</sup> describes budgeting as the actual formulation of plans for future activity. Plans which seek to substitute carefully constructed objectives for hit and miss performance and at the same time provide yardsticks by which deviations from planned achievements can be measured. When the formal quantitative statement of these plans and policies are prepared, this becomes the budget. The budget will cover a specific period and will be used as a guide or blue print for that period. The budget thus becomes the conversion of management plans into figures and can be adequately accomplished only after the preliminary plans, or budgeting, is complete.

The success of the business budget is therefore closely tied to the budgeting which must of necessity precede it. Properly conceived budgeting can mean the difference between a general drift that may or may not lead to a desired objective and a well plotted course towards a predetermined goal that holds drift to a minimum.

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<sup>1</sup>Welsch, 5.

Mapping out a predetermined course of action will not in itself guarantee a profitable operation. The future is highly unpredictable and often uncertain. However, Peter F. Drucker, an often quoted critic of forecasting the future, recognizes the need for adequate business planning:

We know only two things about the future: It cannot be known. It will be different from what exists now and from what we now expect. These assertions are not particularly new or particularly striking. But they have far-reaching implications. Any attempt to base today's actions and commitments on predictions of future events is futile. The best we can hope to do is to anticipate future effects of events which have already irrevocably happened. But precisely because the future is going to be different and cannot be predicted, it is possible to make the unexpected and unpredicted come to pass. To try to make the future happen is risky; but it is a rational activity. And it is less risky than coasting along on the comfortable assumption that nothing is going to change, less risky than following a prediction as to what "must" happen or what is "most probable." . . . The purpose of the work on making the future is not to decide what should be done tomorrow, but what should be done today to have tomorrow.<sup>1</sup>

The general objectives of budgeting are usually summarized in three broad categories: planning, coordinating, and control. Obviously these objectives are not independent of each other. They are so closely related that discussion of one without the other is impossible. The usefulness of any management tool can be justified only by the potential service it provides to management. Therefore the discussion of the objectives of budgeting will first review the function, and then establish the potential service budgeting provides that function.

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<sup>1</sup>Peter F. Drucker, Managing For Results (New York: Harper and Row, 1964), p. 173.



## Planning Function

The managerial planning function is very broad and may be more appropriately described as strategic planning.<sup>1</sup> It encompasses such diverse activities as the development of the basic objectives of the firm, organizational planning, operational planning, and planning for change itself. In order for a manager to know what he should be doing today, he must know what the firm's objectives are five years from today.<sup>2</sup>

The challenges of our dynamic economy requires strategic planning by management comparable in many ways to the strategic planning in our military establishments. Past wars were won by brilliant field generals who operated on the basis of genius, experience, and even hunch. Single battles can still be won by such generals, but wars are won only by planning based on a careful estimate of the total situation. The same is true in business. Short-term success can be achieved through shrewd intuitive decision-making, successful opportunism, personal sales ability, leadership and drive, and even luck. However the long-term success, which requires adjusting to changing conditions and continuing growth and profitability, are largely dependent on careful strategic planning and then a diligent carrying out of the plan. Planning can no longer be limited to the giants of the industry.

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<sup>1</sup>Welsch, 5.

<sup>2</sup>Max D. Richards and William A. Nielander, Readings in Management (Cincinnati: South-Western Publishing Co., 1963), p. 358.

Ewing W. Reilly describes successful business strategy as strategy based on:

1. A searching look within to identify the strengths of the business that can be capitalized on and the limitations that must either be overcome or recognized in realistic planning.

2. A broad look around to be sure that planning takes cognizance of the external factors affecting business success and adequately balances the company's obligations to customers, employees, owners, suppliers, and the community. Those businesses that have geared their policies to the dynamics of the economy, the market and social trends have made the best adjustments to stresses and to opportunities for expansion.

3. And finally, while far-sighted planning has always paid off, today the increasingly long-term nature of business commitments also make a long look ahead almost a necessity.<sup>1</sup>

The heart of strategic business planning is defining and setting up the proper objectives. Management must determine what kind of business the company wants to have and the place in the market to which it aspires. There are few things in life that stand still, and business is not one of them. The business will either grow or decline. Adequate planning can indicate that the company is actually not equipped to grow. For those with the potential, planning may discover that the most valuable growth is not necessarily the most rapid, but the most persistent. Koontz and O'Donnell have described the activities involved in the management planning function.

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<sup>1</sup>Ewing W. Reilly, "Planning the Strategy of the Business," Advanced Management, December, 1955, p. 8.

Planning is the function of a manager which involves the selection from among alternatives of objectives, policies, procedures, and programs. It is thus decision making affecting the future course of an enterprise or a department.

Planning is to a large extent the job of making things happen that would not otherwise occur.

Planning is thus an intellectual process, the conscious determination of courses of action, the basing of decisions on purpose, facts, and considered estimates.

Every plan and all its derivatives must contribute in some positive way to the accomplishment of group objectives.

It encompasses the establishment of objectives which are necessary for all meaningful group effort. In addition, plans must be made to effectuate these objectives before one can know what kind of organization relationships are required, the qualifications of needed personnel, the line or course along which to direct subordinates, and the kind of control to be applied.<sup>1</sup>

All managers plan, for planning cannot be avoided. The question then becomes one of how well or how haphazardly planning is done.<sup>2</sup>

There are few that will argue the fact that most human endeavor is more fruitful if directed by a well-advised and intelligently conceived plan. There are today many business concerns in which the plans for the future are highly indefinite. The questions of where, how, why, and when are decided from day to day as the exigencies of the situation demand. The future success of such businesses is highly questionable.

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<sup>1</sup>Koontz and O'Donnell, pp. 453, 454.

<sup>2</sup>Henry H. Albers, Organized Executive Action (New York: John Wiley and Sons, Inc., 1961), p. 304.

## Budgeting and Planning

The budget was first introduced to business as a control device. However, it soon became apparent that even when using the budget as a control device, management was forced to improve its planning. It was not possible to prepare standards of performance months in advance without giving some thought to objectives, operating conditions, and an acceptable manner of working. Many executives have discovered that the planning required in the budgeting process is as valuable, if not more so, than the subsequent measurement and control.<sup>1</sup>

Budgeting is not necessarily good planning. However a budgeting program, well-designed, can facilitate planning and other aspects of decision-making in a number of ways.<sup>2</sup> The budgeting process gives emphasis to the importance of planning and frequently leads to a more systematic approach to planning problems. More scientific methods in solving forecasting and measurement problems will be promoted. Executives are forced to establish clear-cut objectives and to coordinate their objectives with those of other departments. Participation in the planning process is increased and the flow of information within the management hierarchy is expedited.

A fundamental purpose of business budgeting is to find the most

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<sup>1</sup>William H. Newman and Charles E. Summer, Jr., The Process of Management (Englewood Cliffs, N. J.: Prentice-Hall Inc., 1959), p. 566.

<sup>2</sup>Albers, 319.

profitable course through which the efforts of the business may be directed in meeting its primary objective.<sup>1</sup> Business budgeting requires the combined knowledge, experience, and skill of all echelons of management. It reflects the thinking of many, not just a selected few.

Since the very act of budgeting requires advanced planning, many problems are anticipated before they arise. At an early stage in the planning phase these problems can be resolved. Hasty decisions that must be made on the spur of the moment, more often as matters of expediency than reasoned judgement, are reduced to a minimum.

When the objectives are being defined and policy established, difficult problems cannot be given a temporary solution or postponed to a later date. Everyone in the organization must face up squarely to the problem at hand and arrive at a solution.

Each time the budget is prepared there is a period of critical self-appraisal. Past policies and procedures must be reviewed and weak spots in the organization uncovered. The budgeting process can point out the need for a complete or major revision in the organizational structure.

Profits are the outcome of many interlocking transactions and each element within the firm must make its contribution to the end

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<sup>1</sup>J. Brooks Heckert and James D. Wilson, Business Budgeting and Control (2d ed.; New York: The Ronald Press Co., 1955), p. 4.

objective.<sup>1</sup> If any element is missing or deficient when required, the final objective suffers. The planning process is complicated and management cannot trust to chance. Management, that relies on the vagaries of fortune to arrange its operating scheme, risks running into a wall of problems that could wreck the firm. By budgeting, management establishes a plan of action that gives advanced notice, to all concerned, of the amounts and timing of production factors required to meet desired goals.

### Coordination Function

Not all authorities consider coordination as a separate function of management. Koontz and O'Donnell consider coordination as the essence of managership.<sup>2</sup> They regard each of the managerial functions as an exercise in coordination. The achievement of harmony of individual effort toward the accomplishment of group goals is the purpose of management. It is evident that the importance attached to coordination within an organization is significant regardless of whether it is considered a separate management function or the essence of management.

The necessity for synchronizing individual action arises out of differences in opinion as to how group goals can be achieved or how

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<sup>1</sup>Jerome B. Cohen and Sidney M. Robbins, The Financial Manager (New York: Harper and Row, 1966), p. 283.

<sup>2</sup>Koontz and O'Donnell, 41.

individual and group objectives can be harmonized. Coordination of efforts cannot be expected to take place automatically. Individual

differences and prejudices prevent it. Even in churches and fraternal

organizations individuals often interpret similar interests in different

ways, and efforts toward mutual goals do not automatically mesh with

the efforts of others. Left to themselves, individuals tend to go in

different directions, each one honestly believing that he is acting in the

best interests of the organization. It thus becomes the task of

management to reconcile differences in approaches, timing, effort, or

interest, and to harmonize cooperative and individual goals.

The best coordination of effort occurs when individuals see how

their jobs contribute to the dominant goals of the enterprise. This

implies knowledge and understanding of enterprise objectives by all

concerned--not just top management.

### Budgeting and Coordination

Budgeting provides the instrument of communication through

which the actions of different divisions are coordinated into a single

unit working toward the common objective. All levels of management

held responsible under a budget should have a hand in its preparation

and thus be made fully aware of its aims and objectives. They will in

addition be made aware of the part they are to play in the achievement

of the objectives. A major purpose of budgeting is to reconcile existing

differences, for the good of the whole. Coordination cannot be

accomplished without the assistance and guidance of clearly defined objectives and detailed plans projected throughout the organization.

and standard the other **Control Function**

The control function of management is simply the action necessary to assure that the objectives, plans, policies, and standards are being achieved.<sup>1</sup> To be effective the control function should provide the means to evaluate performance and to compare actual performance with that which was programmed. Deviations must be analyzed and corrective action taken as a result of the analysis. To appraise the effectiveness of the corrective action, follow-up action is required. In addition, the control function must establish the feedback of information to the planning process to improve upon future planning.

A frequently overlooked aspect of effective control is its relationship to the point of action. Control cannot be effective after the fact. There is little that can be done about an expenditure already made or committed, or an inefficiency which is now history. To be effective, control must be exercised prior to the commitment. Responsible individuals must exercise prior control. Predetermined objectives, plans, policies, and standards must be developed and communicated to responsible management. With such information at hand the responsible individual is in a position to exercise control at the point of action.

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<sup>1</sup>Welsch, 13.



## Control and Budgeting

Budgeting is a systematized method for providing definite plans and standards for prior control action and a procedure for keeping management informed of conformity or lack of conformity to such predetermined plans, objectives, and policies. Control implies measurement. Therefore to have adequate control, there must be a yardstick to measure the effectiveness of the entire organization. The comprehensive budgeting program offers such a yardstick. Budgeting will not in itself control, but it provides an effective approach for accomplishing the basic management responsibilities of control.

Due to the early application of the budget in business, the control function has wrongfully become associated with cost reduction. Although cost reduction certainly can be one of the aims of budgeting, it is seldom the primary function. To meet the firm's objectives there are times when even higher spending is called for. Budgeting does not determine how little is to be spent but the amount required to achieve the desired goals.

The management group of a large organization is very small compared with the number of employees under its supervision or control. It is impossible for these few individuals to follow closely the myriad of interrelated activities that the business carries on. To maximize effectiveness, management must delegate responsibilities in order to maintain a broad perspective of the entire operation. A sound budget program erects the framework for achieving this objective.

## CHAPTER IV

### BASIC CONSIDERATIONS IN BUDGETING

To accomplish the desired objectives of budgeting there are certain basic considerations in planning, executing, and control which must receive adequate management attention. These considerations include the essential prerequisites, fundamentals of the budgeting process, budget period, and the limitations in budgeting.

#### Essential Prerequisites

A firm foundation upon which to build is an essential prerequisite for most all tools of management. Budgeting is no exception.

The firm foundation must be based on (1) sound organization, (2) satisfactory accounting, (3) support of major executives, and (4) adequate research and analysis.

Sound organization. -- One of the advantages of budgeting is that in the process of budgeting weakness in the organization will be revealed. However, it is conversely true, that the budget cannot be successfully developed until the firm is properly organized.<sup>1</sup>

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<sup>1</sup>Robert N. Anthony, John Dearden, and Richard R. Vancil, Management Control Systems (Homewood, Illinois: Richard D. Irwin, Inc., 1965), p. 196.

Satisfactory organization is the first essential to successful budgeting. Reduced to its simplest terms, organization consists of an intelligent grouping of tasks, a coordination of the work of groups, the establishment of definite lines of authority and responsibility in the execution of the tasks, and a procedure for the enforcement of the responsibility so assigned.<sup>1</sup> For effective budgeting, responsibility and authority must be clearly defined for all functions. In the absence of such clear-cut organizational lines it is impossible to place responsibility for performance and difficult to secure the required data for the budgeting process. These same principles must apply to the budgeting function itself. Someone or some unit must be definitely placed in charge of the budgeting procedure, and the responsibility of each official in regard to budgeting must be clearly defined.<sup>2</sup>

Satisfactory accounting. -- The accounting records are not sufficient if they show only sales, costs, and profits. To be most useful in budgeting the records must reveal what goods were sold, to whom, how, and where. Accounting techniques should be fashioned so that management will have the information required to evaluate the operating facts. It is essential for good budgeting that the accounting records reveal operations in all the necessary relationships.

Support of major executives. -- One of the rocks on which many

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<sup>1</sup>Heckert and Wilson, 20.

<sup>2</sup>Cohen and Robbins, 287.

systems founder and eventually fail is the lack of top management support.<sup>1</sup> To be a success, the budgeting program must of necessity have the full support of every member of management. All must be aware of the needs and advantages of budgeting to them as individuals and to the business as a whole. The procedural requirements of the budget task can be delegated, but the final impetus and direction necessary to motivate action must come from the very top. The budgeting program must not only have the support of management but must also have its confidence. Management must be convinced that it is their responsibility to plan such influence.

Adequate research and analysis. --It is the responsibility of management to know not only what has been attempted, what has been accomplished, and what has failed, but also what should be accomplished.<sup>2</sup> Adequate research and analysis is basic to the fulfillment of this responsibility and required for a successful budgeting program.

#### The Fundamentals of the Budgeting Process

In isolating the basic fundamentals in budgeting a distinction should be made between the mechanics of budgeting, the techniques of budgeting, and the fundamentals of the budgeting process. Glenn A. Welsch has made the following distinction:

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<sup>1</sup>Anthony, Dearden, and Vancil, 198.

<sup>2</sup>Robert H. Wessel, Principles of Financial Analysis (New York: The McMillan Co., 1961), p. 29.

The mechanics of budgeting have to do with such matters as design of budget schedules, clerical methods of completing such schedules and routine computations.

The techniques of budgeting are special approaches and methods of developing data for managerial use in the decision-making process.

The fundamentals of the budget process are concerned directly with the basic functions of management, particularly the planning and control.<sup>1</sup>

It is with the acceptance of this definition that the significant fundamentals of the budgeting process will be presented. The most complete list is that presented by Sord and Welsch and includes:

1. A formalization and integration of:
  - a. The planning process.
  - b. The control process (including related procedures and techniques employed).
2. A formalization and integration of the budgeting system into a coordinated program consistent with organizational responsibilities and planning and control needs.
3. A definite and clear-cut assignment of responsibility for:
  - a. Budget estimates related to operation assignment.
  - b. Over-all staff coordination of the budget program.
4. A budgetary system that provides for:
  - a. Definite time schedules for the completion of formal plans consistent with specific planning responsibilities.
  - b. Timely reporting of results related to objectives.
  - c. Prompt control action related to organizational responsibilities.
5. Operating plans for the firm and for each major organizational division thereof (formalized and expressed in detail).
6. A reporting system which compares actual results with standards or objectives by areas of organizational responsibility (applying the exception principle).

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<sup>1</sup>Welsch, 26.

7. Simple procedures, applied to the fullest extent possible, consistent with the requirements of the situation.
8. A system whereby all levels of management actively participate in the planning and control process.
9. A recognition of the significant differences existing between the planning process and the control process, and an appreciation of the interrelationships between the two processes.
10. A program of continuous budget education to insure appreciation of the potentials involved, and an increasingly enlightened approach in the application of budgeting.
11. Active support and participation in the budgeting program from top management to the lowest level of supervision.
12. A periodic follow-up to appraise the implementation of budgetary policies and control procedures by the lower levels of management.
13. A clear understanding and appreciation by both line and staff personnel of line and staff relationships.
14. Provisions for enlightened budgetary staff assistance to lower-level supervisors when needed.
15. A continuous participation by both line and staff in the solution of day-to-day problems.
16. An adequate recognition of an emphasis on the importance of enlightened human relations in generating a spirit of willing cooperation among persons associated in an enterprise.
17. A system of budgeting designed and applied primarily to motivate people rather than to exert pressure on individuals.
18. An appreciation of the difference between "job responsibilities" and control techniques.
19. A recognition of the fact that control is accomplished through people rather than through the techniques.<sup>1</sup>

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<sup>1</sup>Burnard H. Sord and Glenn A. Welsch, Business Budgeting (New York: Controllershship Foundation, Inc., 1962), pp. 38-41.

Although the list may seem long, each is important in the success of a budgeting program. An additional fundamental which was not adequately expressed was that the budgeting program must be designed to fit the needs of the business.

### The Budget Period

The length of the budget period varies not only with the company, but also with the nature of the budget. The purpose of the plan and the reliability of the information are considerations which should guide the decision. Some firms with long-established budgeting programs are able to plan three, five, ten, and even twenty years in advance. Others with less experience limit their forecasts to periods of one or two years.

There are advantages and disadvantages in both long-term and short-term budgeting and the choice must be made judiciously. Shorter periods offer the advantage of greater accuracy in preparing estimates of future activity. Forecasts for long periods of time may become no more than an educated guess. Short-term budgets are unable to take advantage of one of the objectives of budgeting--the anticipation of problems long before they appear--which enables the firm to make the necessary adjustments for a satisfactory solution.

To secure the full benefits of budgeting the budget period should be as long as circumstances permit. Such considerations as normal turnover periods, seasons, length of production period, and

general business conditions can be important factors. Periods are usually shorter in times of marked uncertainty than under more stabilized conditions. For whatever period is selected it must be remembered that frequent revisions may be necessary in all but the most stable companies.

#### Limitations in Budgeting

The success of the budgeting program may well depend upon a complete understanding by management of the budgeting limitations. The limitations will not detract so much from the effectiveness of the budgeting program as long as they are understood. These limitations are presented by Welsch as follows:

1. The budget plan is based on estimates. The strength or weakness of a budget program depends to a large degree on the accuracy with which the basic estimates are made. The estimates must be based on all available facts and good judgement. The estimating of sales and expenses cannot be an exact science; however, there are numerous statistical and other techniques that may be effectively applied to the problems which, when tempered with sound reasoning and judgment, produce satisfactory results. If there is conviction that such estimates can be made, a serious effort generally gives adequate results. Because the budget plan is based extensively on estimates, judgement is necessary in interpreting and using the results.
2. A budget program should be continually adapted to fit changing circumstances. A budget program generally cannot be installed and perfected in a short time. Budget techniques must be continually adapted, not only for each particular concern, but for changing conditions within the concern. Various techniques must be tried, improved, or discarded and replaced with others. In other words a budget program must be dynamic. Continuous budget education is necessary, especially during the formative period.



3. Execution of a budget plan will not occur automatically. Once the budget is completed, the plan will be effective only if all responsible executives get behind it and exert continuous effort toward its accomplishment. All levels of management must be sold on budgeting and must participate in the program.
  
  4. The budget will not take the place of management and administration. Budgeting does not take the place of management; it is a tool. The budget manual of one prominent concern reads as follows on this point: "The budget should be regarded not as a master, but as a servant. It is one of the best tools yet devised for advancing the affairs of a company and of the individuals in their various spheres of activity. It is not assumed that any budget is perfect. The most important consideration is to make sure, by intelligent use of the budget, that all possible attainable benefits are derived from the budget as rendered."<sup>1</sup>
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<sup>1</sup>Welsch, 22-23.

## CHAPTER V

### CONCLUSION

This study has revealed the potential value of budgeting as a management tool to assist in the planning, coordinating, and control functions. The advantages to be gained provide sufficient justification to warrant the claims of those who consider the budget an essential tool for effective management. The justification for any management tool must rest upon its potential service to management. A sound budgeting program can well meet this test.

The flexibility of a budgeting program provides a useful and meaningful tool regardless of the size or objectives of the organization. To obtain the maximum effectiveness the budget should be tailored to meet the needs of the organization. The program must be comprehensive and represent functional standards that integrate and guide the company's operations.

The advances made in the last decade in scientific management have been impressive. The introduction of computers and analytical techniques have not detracted from but have actually added greater significance to the budgeting program. The introduction of the program budgeting concept represents a considerable advancement and the existence of a sound budgeting program is essential if management is

to be in a position to benefit from these new concepts and techniques.

The benefits derived from a budgeting program reflect the care and effort it receives. Many firms are well grounded in constructive budgeting and obtain from it a sense of balance and direction. Too many others have failed to recognize the basic considerations which must be applied and the confusion that results have limited, if not completely eliminated, the effectiveness of this management tool.

In the successful budgeting program management must recognize the basic considerations which must receive continuing attention. They must be aware of the limitations. Last, and probably the most important, the budget is a tool which will significantly assist management in performing the functions of planning, coordinating, and control but it will not plan; it will not coordinate; and it will not control. It most definitely is a tool which can be effectively used by management but it will not replace management.

## CHAPTER VI

### RECOMMENDATIONS

To determine the specific action to be taken to improve upon a budgeting program, it is recommended that management initiate a searching self-examination of existing practices in light of the basic considerations established. Having identified those practices which abuse these considerations the required or corrective action will become evident.

Management must also recognize that in the final analysis all of the basic considerations reflect an involvement of people. Without exception a management tool can be used effectively only if the hand that guides it is properly motivated. Great numbers of people have acquired a defensive approach to the subject of budgeting through painful experience. The foremen are people first and supervisors second and the same is true with most managers and top executives. Past budgets have represented restrictions and people in general have an aversion to restraint. Too many have been introduced to the budget when it was blamed for their failure to get an increase in pay or as a barrier to spending. It is not surprising therefore to find that budgeting represents restriction rather than the more positive aspects of planning and coordination.

It is evident that the attitude of those individuals responsible for implementing and working under the guidance of a budgeting program is an important key to its success--a key which has often been overlooked by management. The budget must live in an atmosphere of

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perpetual adjustment to the needs and capacities of people. To be successful under the conditions in which it operates, it is recommended that the budgeting program be designed to provide for and thrive on such fundamentals as recognition of accomplishment, consideration for the rights of individuals, and fair play.

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