

BUSINESS BUDGETING AND CONTROL

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PREFACE

The challenge presented to American business leadership at this time is perhaps unparalleled in all industrial history. To meet this challenge two basic responsibilities must be accepted. First, business leadership at large must accept and make effective the principle that social responsibility transcends the selfish interest of the individual business concern—its management and controlling owners. This is no mere platitude; it is fundamental to the very existence of free business enterprise. Through intelligent planning the cycles of industrial activity must be made less severe, regularity and security of employment must be provided for all deserving workers, and there must be a far greater refinement in the mechanism of providing incentives for individual effort and in the reward of individual merit. The maintenance of free enterprise depends far more upon industry's ability to provide regular employment and opportunity to the rank and file of deserving workers than upon supplying a dead level of subsistence to both deserving and undeserving. Second, both management and workers must increase their skills. Operations must be better planned and more expertly directed; wastes of time and materials must be reduced in the face of more intensive worldwide competition. It is industrial efficiency rather than legislation that will ultimately provide shorter working hours and a higher standard of living.

But the whole of industry will be no better than its parts. The individual business must be better planned and more efficiently organized and operated if the whole of American industry is to continue its forward progress.

In order fully to meet their responsibilities business executives must constantly improve the managerial tools for the direction and control of business. One such tool, and the one with which this book is concerned, is formal budgeting. Every business must do a certain amount of planning and looking

forward, but such work is apt to be irregular and ineffectual unless it is reduced to a definite orderly procedure. "We can never see the future as clearly as the past," says E. Stewart Freeman, well-known exponent of budgeting, "but foresight has the one great advantage that it can remedy many things which a more competent hindsight can only regret. Imperfect plans based on the best information and judgment available at least provide management control, coordination, perspective, and education, and establish the necessary foundation upon which better plans can be constructed."

This book has been written for university students in the fields of accounting and management, for business executives upon whom falls the ultimate responsibility for planning and control, and for accounting officers who largely direct the budgeting and control procedure.

While budget procedure has been fairly well developed in most of the very large concerns of this country, there are thousands of small and medium-sized companies in which adequate budget and control procedure is lacking. There is, however, rising up in these concerns a new generation of executives and accountants whose training and experience is being directed to scientific methods of business planning and control. It is particularly to this group and to students who will enter this field that the suggestions of this book are directed.

The suggestions made here are based primarily on the author's experience during the past twenty years in developing budgetary procedure for various concerns and in teaching courses in budgeting to university students. While the specific problems of budgeting and control vary somewhat in concerns of different type, the basic purpose, objectives, and method of approach to the problems are fundamentally the same in all types of business. It is these that have been especially stressed.

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BUSINESS BUDGETING
AND CONTROL

CHAPTER 1

PURPOSE OF BUDGETING

Need for Intelligent Planning.—Most human endeavor is more fruitful if directed by a well-advised and intelligently conceived program. The conduct of business is no exception. There are, however, many business concerns in which the plans for the future are highly indefinite—far more so than necessary. These concerns are simply on their way—where, how, why, and when are questions which are decided from day to day as the exigencies of the situation demand. No sustained and continuous effort is made to chart a future course which would seem, all circumstances considered, to point the surest way toward the ultimate port of business success. If you question the general executives in such concerns, you will usually find that they have some vague ideas as to a program but that no intensive study has been made to determine whether such a general course is the most profitable one which could be pursued. If you question the sales executives, you will find that they expect to do 10% more business than last year, although in just what products or territories or by what sales projects there will be only vague ideas. If you question the production executives, they will tell you that their program depends largely upon sales orders and that naturally these cannot be known in advance. As the orders come in they will make their plans accordingly. If you closely question minor executives, superintendents, department heads, foremen, and salesmen, you will find that few of them actually know just what the management is trying to accomplish. Their programs will actually be to go along from day to day as best they can, hindered as frequently they are by uncertainty as to the general program.

In such concerns, operations would be more efficiently conducted and profits would be greater if management gave careful

study and attention to planning its activities in advance. Many concerns, particularly some of the large American corporations, are now giving the most exacting study to this phase of the management task, but thousands of others are either neglecting the task entirely or planning their operations in a superficial manner.

Advantages Gained by Business Budgeting.—The fundamental purpose of business budgeting is to find the most profitable course through which the efforts of the business may be directed and to hold the business to that course. In most business concerns there are numerous decisions to be made as to the policies to be followed and the methods to be used. Decisions must be made, for example, as to the choice of goods and services which are to be made and sold, the selection of customers, the level of prices, methods of production, methods of distribution, credit terms, methods of financing, degree of integration of operating units, and so on, almost without limit. Which selection of policies and methods will be most profitable? Can any combination be found which gives reasonable promise of an adequate return on the investment? If none can, the venture should be stopped, the business merged with another, or the capital shifted to other channels, before further losses result. If profitable courses are open, each should be examined and translated into its profit possibilities.

While it is easy to speak in general terms of the desirability of budgeting, the practical advantages in an actual case are not always so apparent. Conditions change rapidly in business; the actions of customers and competitors cannot be entirely controlled and after they become known a business must, to a degree, govern itself accordingly, regardless of any previously developed program. Plans, when made intelligently, require exhaustive study and research, and this constitutes an expensive procedure. What, then, are the specific advantages to be gained? These may be summarized as follows:

1. *To base action upon thorough investigation, study, and research.* Perhaps the cardinal advantage of systematic budgeting is that it tends to bring the executives to an early study of their problems and instills into the organization the habit of

careful study before decision as to action. This is not easy to achieve. Intensive study is to many a distasteful exercise. Most of us prefer to postpone difficult decisions until necessity compels. Businesses as individuals tend to become opportunists; they wait until a decision is forced, then turn quickly, often without time for careful study of the problems, in the direction offering the easiest immediate escape from their troubles.

If the executives, from general manager to foremen, know that their plans are to be formally expressed and that they will be charged with responsibility for their execution, they can be brought to an earlier and more intensive study of the problems at hand.

2. *To enlist the assistance of the entire organization in determining the most profitable course.* When budgeting is undertaken in ample time and on a regular schedule, there is full opportunity to enlist the assistance of foremen, salesmen, branch managers, department heads, and all operating officials—major and minor. In some lines of business the suggestions and counsel from such sources are essential to the development of the best operating plans, and in most lines of business such assistance is highly desirable. The final plans should be expressive of the combined judgment of the entire organization, thereby eliminating such bias or prejudice as frequently affects the judgment of individual groups.

3. *To serve as a declaration of policies.* Nothing so restrains the enthusiasm and energy of an organization as uncertainty. The budget procedure provides a vehicle through which basic policies are periodically reexamined, restated, and set forth as guiding principles for the organization at large. Basic policies, not temporary expediency, should be the guiding factors of a business and the organization should be schooled in such policies.

4. *To define objectives.* The successful manager must surround himself with capable associates who will accept his leadership and execute his program. But he must demonstrate his ability to lead. Men will follow a leader when they realize that he has a sensible plan of action and definite objectives in mind. Such objectives should be clearly expressed, and, to a certain degree, should stand as goals of attainment for the entire organi-

zation. Objectives, however, must not be the product of hope but rather the logical consequence of carefully laid plans. The executive who can clearly define his objectives and delineate a program which can logically be expected to reach such objectives can command the cooperation and loyalty of his associates.

5. *To relate the activities of the business to the expected general trend of business conditions.* Numerous studies have been made which would seem to indicate that profits are fully as much (if not more) the result of changes in fundamental conditions as of competitive efficiency. This emphasizes the importance of coordinating the plans of the business with the general trend of economic conditions. The failure of economists to agree upon the causes of the business cycle and the frequent difference of opinion among business analysts as to future trends have led many executives to the point of skepticism regarding the whole matter of forecasting; however, the fact remains that business moves through periods of activity and depression and that there are frequently signals of the movements as related to a particular business. These signals must be watched and the plans of the business must reflect courage or caution depending upon the expected trend.

6. *To direct capital and effort into the most profitable channels by means of a balanced and unified program.* Before spending money it is well to give serious study to the amount which can be profitably spent, where it is to come from, just how it should be spent, and what results may be reasonably expected. A certain amount of funds must be directed toward equipment and inventories and a certain amount to the promotion of sales; but these amounts must be kept in proper balance. No more should be attempted than that for which there is available capital, no more should be made than that which can be profitably sold, and no sales program should be developed beyond that needed for the planned production. Such a balance of factors directed toward a definite objective represents the ideal and, while it can seldom be fully achieved in practice, its achievement will be more likely as a result of careful advance planning. Without such planning, inventories are likely to be out of proportion to sales and production requirements, custom-

ers may be excessively financed, and irregularity is likely to arise in the use of production facilities.

Where plans and decisions are made from day to day, the program frequently becomes unconsciously warped. Executives are often, through previous training or experience, biased in the direction of sales, engineering, or finance, with the result that one factor receives a disproportionate emphasis. A well-balanced program set up in advance and based upon careful study will help to avoid this danger.

7. *To coordinate and correlate effort.* In some respects this is the most important purpose of budgeting. In many concerns there is a definite lack of coordination of effort. This is a restraining factor. Full steam cannot be applied in some divisions of the business because of uncertainty as to the program in other divisions. Only when the effort of all divisions is properly timed and coordinated can the full power of united action be secured.

This, however, emphasizes another important element of budgeting and that is the necessity of constant review and revision of the plans. If unforeseen and uncontrollable situations arise (and in many industries this is certain to happen), which materially alter the operations of one division, the machinery must be available for quick readjustment of the program in other divisions affected thereby. Wars, floods, drouths, strikes, price wars, political changes, collapse of foreign markets, etc., give rise to such situations.

The success of business budgeting should be measured not so much by the nearness of the ultimate results to the original plans as by the extent to which all executives—major and minor—know at all times just what is the immediate program and what are their respective parts therein. There must be no restraint of uncertainty if the organization is to function with full power.

The chief executive is the final coordinating official but the complexities of the modern business are such that he cannot exercise this function without the assistance and guidance of clearly defined objectives and detailed plans which are projected throughout the entire organization.

8. *To control operations.* While the primary purpose of budgeting is to ascertain the most profitable course for the business to follow and to develop a balanced and coordinated program which will hold the company to that course, the budget also provides a valuable tool of control over certain business operations.

Some operations and expenditures are subject to very definite control. It may be decided, for example, that \$200,000 should be invested in plant expansion, that \$100,000 should be appropriated for various sales promotion projects related to a new product, that 1,000 units of the new product should be sold during the period under consideration, and that these units should be manufactured at a cost of \$200 each. Assuming that the plans have been predicated upon careful study and the considered judgment of the entire organization, the foundation has been laid for a certain degree of control. The investment in plant can be rigidly held to the prescribed limits in spite of the enthusiasm of production officials to go beyond. Likewise the expenditure for sales promotion can be definitely held to the predetermined plan. To be sure, the orders for 1,000 units may not be realized. This might result from the fact (1) that external conditions have changed rapidly and that such changes could not be foreseen; or (2) that the sales promotion projects were not as effective as expected; or (3) that the production of the units—either in quantity, or cost—has not met expectations. In such cases the budget provides a certain degree of control. Expenditures are limited and directed into the channels which offered most promise. If external conditions beyond the control of management change, the program must be promptly revised. If such conditions do not change and failure of execution lies within the organization, the budget serves as a very definite tool of control. The failure of sales and production performance to meet expectation provides the signal for corrective action.

9. *To reveal weakness in organization.* As plans are made and the responsibility for their execution delegated, weaknesses in organization will be revealed. Executives will not accept responsibility unless lines of authority are so delineated that they will be unhampered in the execution of their tasks. Where

joint responsibilities are necessary, provision must be made in advance for an orderly procedure of joint action. No management activity so quickly reveals weakness in organization as the procedure of systematic budgeting.

10. *To stabilize employment and to make more effective use of physical equipment.* No employer of labor, regardless of his social or economic philosophy, can longer disregard the welfare of his employees. We have passed the time when workers can be laid aside at will when not needed, as flasks or patterns in the foundry. To be sure the responsibility to workers must be balanced with the responsibility to investors and the welfare of both must be considered, but the business program must consider stability of employment. Intelligent business budgeting rather than governmental regulation offers the greatest hope for providing stability of employment. Moreover, budgeting likewise promotes the economical use of physical equipment.

11. *To prevent waste.* A searching inquiry in advance, of every contemplated expenditure and the reason therefor, extended to every function and department of the business, constitutes the most effective preventive of waste.

Confusion as to Purpose of Budgeting.—In the actual work of developing the budget for a business concern, the question almost immediately arises as to whether the program should be based on standard performance or actual expectation, accepting as inevitable the fact that not everybody in the organization will at all times come through with satisfactory performance.

In the considerable amount of literature on the subject of business budgeting there has been much confusion on this point, with the result that the term *budgeting* does not have a well defined and generally accepted meaning. This confusion rests chiefly on the assumption made as to the ultimate purpose which the budget is to serve. If the budget is to serve primarily as a measure of individual performance, then it should be based on standard performance. If, on the other hand, it is to serve primarily as a tool of coordination of operating and financial factors, then it should be based on actual expectation—good or bad.