LISBON SCHOOL OF ECONOMICS & MANAGEMENT
UNIVERSIDADE DE LISBOA
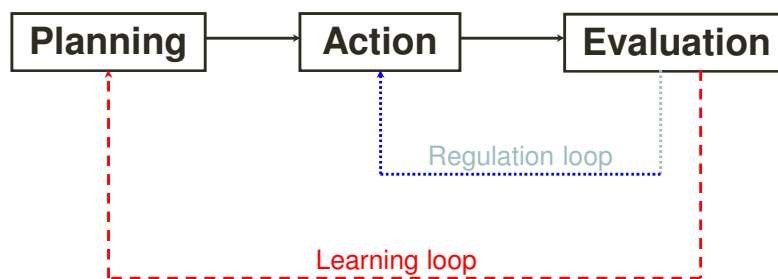
BUDGETING PROCESS

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Professor
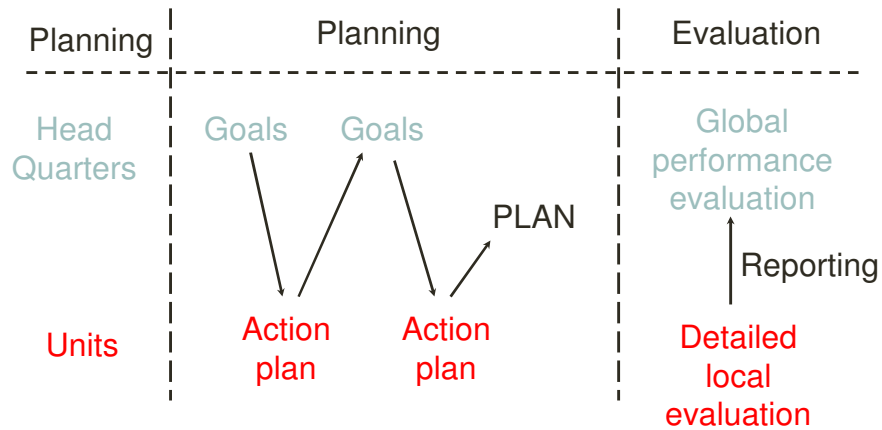Management, Corporate Finance & Real Estate
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AGENDA

1. The management control process

2. Purpose & preparation of budgets

1. The Management Control process

PHASES AND LOOPS OF THE PROCESS

| Planning | → | Action | → | Evaluation |

Regulation loop

Learning loop

RESPONSIBILITY IN THE PROCESS

Planning	Planning	Evaluation

Head Quarters — Goals → Goals → PLAN

Global performance evaluation

↑ Reporting

Units — Action plan — Action plan

Detailed local evaluation

OBJECTIVES OF THE PLANNING PROCESS

Imagine action plans that create value

Anticipate

Validate action plans

Mediate between action plans

Prepare evaluation (variance analysis)

TIME HORIZONS OF THE PROCESS

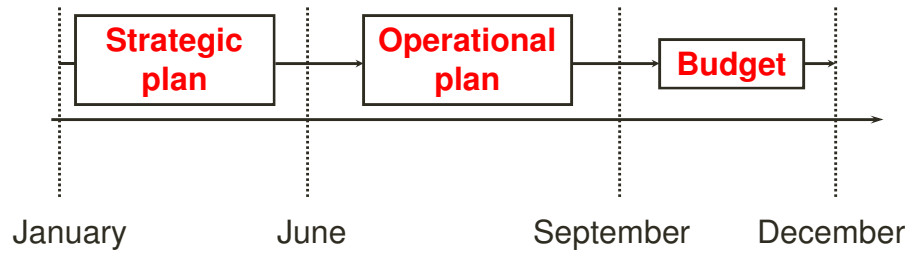Planning sets goals to achieve & action plans and

resources to do so

Time horizon depends on the type of goal and the means

required to achieve this goal

TYPES OF PLANNING

Type of planning	Time horizon	Level of details in forecast	
		Financial	Operational
Strategic plan	LT 5 yrs +	Not much detail	> 3 years consequences
Operational plan	MT 3 yrs +/-	Company level	> 1 year consequences
Budget	ST 1 yr	Unit level	> 1 month consequences

TYPICAL PLANNING AGENDA

Typical calendar

| Strategic plan | → | Operational plan | → | Budget |

January   June   September   December

PLANNING IN A DECENTRALIZED FIRM

In a decentralized context, planning is a useful tool for

solving ***coordination*** and ***strategic alignment*** problems

Budget can be used to solve ***both*** problems

2. Purpose and preparation of budgets

COST ALLOCATION FOR MGT CONTROL

Allocation of costs to cost objects is inappropriate for cost control and performance measurement

Costs and revenues must be traced to the individuals who are responsible for incurring them *(responsibility accounting)*

RESPONSIBILITY ACCOUNTING

Recognition of individual areas of responsibility in a firm's structure

These areas are called "responsibility centers" (organization unit for whose performance a manager is held responsible)

WHAT IS A BUDGET ?

A budget is a financial and quantitative summary of an action plan for a forthcoming accounting period

Types of budget:

- Functional (sales, production, etc.)
- Capital investment and cash budgets
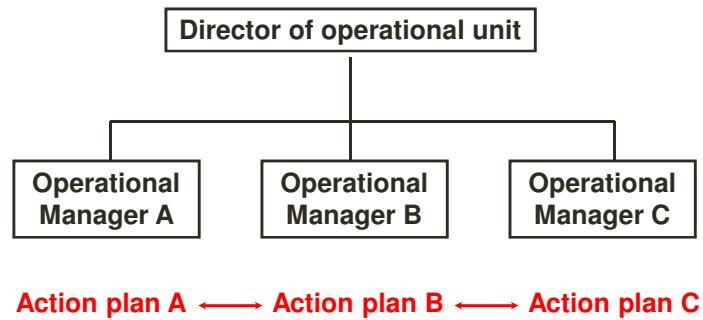- Master budget (includes all budgets)

PURPOSES OF BUDGETS

Coordinate activities of sub-units

Communicate policies and goals

Establish a system of performance evaluation (incitation & motivation)

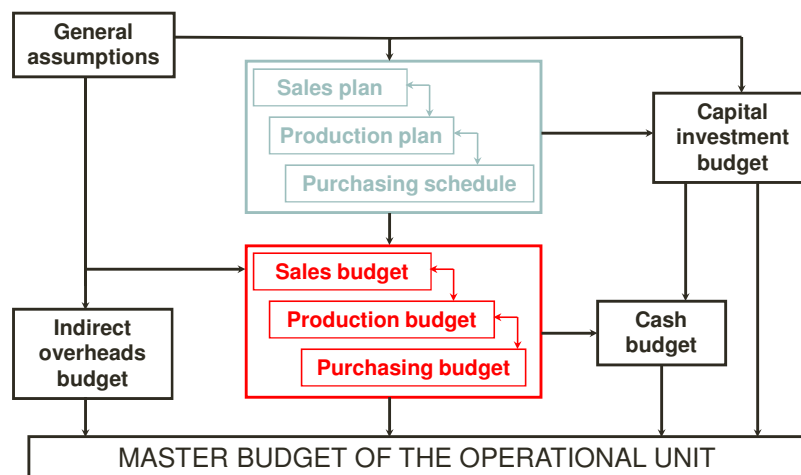Compel planning

BUDGET AS A COORDINATION TOOL

The budgeting process should:
- Guarantee the coherence of action plans
- Favor the discussion of action plans
- Take into account the inter-dependency of action plans
- Memorize assumptions made and qualitative aspects of action plans

COORDINATION OF ACTION PLANS
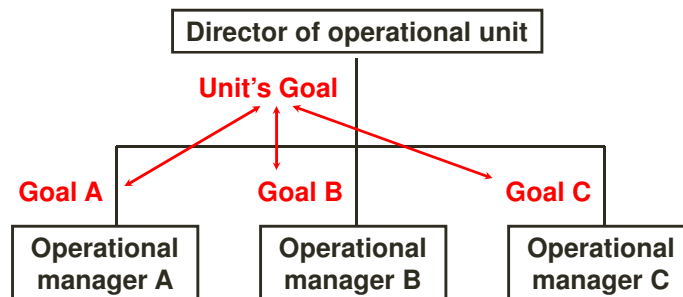
PREPARATION OF BUDGETS

BUDGET AS A STRATEGIC ALIGNMENT TOOL

The consolidation of action plans should lead to forecasts in road with the global performance objectives

Action plans must be aligned with strategic goals

STRATEGIC ALIGNMENT   OF ACTION PLANS

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                    ┌─────────────────────────────┐
                    │ Director of operational unit │
                    └─────────────────────────────┘
                              Unit's Goal

          Goal A              Goal B              Goal C
      ┌─────────────┐    ┌─────────────┐    ┌─────────────┐
      │ Operational │    │ Operational │    │ Operational │
      │  manager A  │    │  manager B  │    │  manager C  │
      └─────────────┘    └─────────────┘    └─────────────┘
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LIMITS OF BUDGETS

Justify already taken decisions

Prevent from adaptation to change

Useless because goals are imposed

Increase rivalry between departments

Technocratic procedure

THE BUDGET PARADOX

Paradox between different purposes:

- Incitation vs. regulation

- Incitation vs. coordination

- Incitation vs. learning

BEYOND BUDGETING?

Complaints are linked to the anticipation function of budgets, which is less useful when environment is changing rapidly

But don't forget the regulation and learning functions: don't throw the baby *(theory)* with the water of his bath *(practice)*