

## Case 10-1: Emerson Electric Company

Emerson Electric Company was founded in 1890 as a manufacturer of motors and fans. In 1993, Emerson marked its thirty-sixth consecutive year of improved earnings per share. On \$8.2 billion sales, the diversified St. Louis based company reported a 1993 profit of \$708 million. In addition, the company had \$2 billion in unconsolidated sales in international joint ventures. It manufactures a broad range of electric, electromechanical, and electronic products for industry and consumers. Brand names include Fisher Control Valves, Skil, Dremel, and Craftsman power tools, In-Sink-Erator waste disposals, Copeland compressors, Rosemount instruments, Automatic Switch valves, and U.S. Electric Motors in the power transmission market. Since 1956, Emerson's annual return to shareholders averaged 18 percent. Sales, earnings per share, and dividends per share grew at a compound rate of 9 percent, 8 percent, and 7 percent, respectively, over the 1983-93 period. Inter-national sales have grown to 40 percent of total sales and present a growth area for the company.

Emerson is a major domestic electrical manufacturer. Its U.S. based competitors include companies such as General Electric, Westinghouse, and Honeywell. Its foreign competitors include companies such as Siemens and Hitachi. Emerson has had the narrowest focus as a broadly diversified manufacturing company among its primary competitors. Other manufacturers, such as GE and Westinghouse, are diversified into financial services, broadcasting, aircraft engines, plastics, furniture, etc. Emerson follows a growth-through-acquisition strategy, but no one acquisition has been very large. There are periodic divestitures as management seeks the appropriate or complementary mix of products.

In 1973, Charles F. Knight was elected Chief Executive Officer, after joining the company the prior year. Under Knight's leadership, Emerson analyzed historical records as well as data on a set of "peer companies" the investment community valued highly over time. From this

analysis, top management concluded that Emerson needed to achieve growth and strong financial results on a consistent basis reflecting constant improvements. The company set growth rate targets based on revenue growth above and beyond economy-driven expectations.

During the 1980s, the company maintained a very conservative balance sheet rather than using leverage. Top management felt that this was a competitive weapon because it permitted flexibility to borrow when an attractive business investment became available. In the economic downturn of the 1990s, Emerson, unlike a number of companies, was not burdened by heavy debt and interest payments.

### ORGANIZATION

Historically, Emerson was organized into 40 decentralized divisions consisting of separate product lines. A president ran each division. The goal was to be number one or two in the market for each product line. The company resisted forming groups, sectors, or other combinations of divisions as found in other large companies until 1990, when Emerson organized its divisions into eight business segments: fractional horsepower electric motors; industrial motors; tools; industrial machinery and components; components for heating and air conditioning; process control equipment; appliance components; and electronics and computer support products and systems. This new structure exploits common distribution channels, organizational capabilities, and technologies.

The Office of the Chief Executive (OCE), which consists of the Chief Executive Officer, the President, two Vice Chairmen, seven business leaders, and three other corporate officers, directs management of the company. The OCE meets 10 to 12 times a year to review division performance; and discuss issues facing individual divisions or the corporation as a whole.

Each division also has a board of directors, which consists of a member of the OCE who serves as chairman, the division president, and the division's key managers. The division boards meet monthly to review and monitor performance.

Corporate staff in 1993 consisted of 311 people, the same number as in 1975, when the company was one-sixth its current size in terms of sales. Staff is kept to a minimum because top management believes that a large staff creates more work for the divisions. To encourage open communication and interaction among all levels of employees, Emerson does not publish an organization chart.

In the early 1980s, the company was not globally competitive in all of its major product lines, and recognized that its quality levels in some product areas did not match levels available from some non-U.S. competitors, particularly the Japanese. Therefore, top management changed its twenty-year strategy of being the "low cost producer" to being the "best cost producer." There were six elements to this strategy:

1. Commitment to total quality and customer satisfaction.
2. Knowledge of the competition and the basis on which they compete.
3. Focused manufacturing strategy, competing on process as well as product design.
4. Effective employee communications and involvement.
5. Formalized cost-reduction programs, in good times and bad.
6. Commitment to support the strategy through capital expenditures.

Since the 1950s, the low cost producer strategy required the divisions to set cost-reduction goals at every level and required plant personnel to identify specific actions to achieve those goals. Improvements of 6 percent to 7 percent a year, in terms of cost of goods sold, were targeted. With the best-cost producer strategy, Emerson now aims for higher levels of cost reduction through its planning process. For example,

machine tools were used to streamline a process to save labor costs, and design changes saved five ounces of aluminum per unit. Sometimes a competitor's products were disassembled and studied for cost improvements. Products and cost structures of competitors were used to assess Emerson's performance. Factors such as regional labor rates and freight costs were also included in the analyses. For example, before investing millions of dollars in a new plant to make circular saws, top management wanted to know what competitors, domestic and global, were planning.

In the period 1983 to 1993, capital investments of \$1.8 billion were made to improve process technology, increase productivity, gain product leadership, and achieve critical mass in support of the best-cost producer strategy. Division and plant management report every quarter on progress against detailed cost reduction targets.

Quality was an important factor in Emerson's best-cost producer strategy. Improvements were such that Emerson was counting defects in parts per million. For example, in one electric motor line, employees consistently reached less than 100 rejects per one million motors.

## PLANNING PROCESS

CEO Knight made the following comments on Emerson's planning process:

Once we fix our goals, we do not consider it acceptable to miss them. These targets drive our strategy and determine what we have to do: the kinds of businesses we are in, how we organize and manage them, and how we pay management. At Emerson this means planning. In the process of planning, we focus on specific opportunities that will meet our criteria for growth and returns and create value for our stockholders. In other words, we "identify business investment opportunities."<sup>1</sup>

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<sup>1</sup> Knight, C. F., "Emerson Electric: Consistent Profits, Consistently," *Harvard Business Review*, January-February 1992, p. 59.

Emerson's fiscal year starts October 1. To initiate the planning process, top management sets sales growth and return on total capital targets for the divisions. Each fiscal year, from November to July, the CEO and several corporate officers meet with the management of each division at a one or two day division planning conference. Knight spends 60 percent of his time at these division-planning conferences. The meetings are designed to be confrontational in order to challenge assumptions and conventional thinking. Top management wants the division to stretch to reach its goals. It also wants to review the detailed actions that division management believes will lead to improved results.

Prior to its division planning conference, the division president submits four standard exhibits to top management. Developing these four exhibits requires months of teamwork and discipline among each division's operating managers.

The "Value Measurement Chart" compares the division's actual performance five years ago (1989), the current year's expected results (1994), and the long-range forecast for the fifth year (1999). See **Exhibit 1** (Note: the numbers in all exhibits are disguised). The Value Measurement Chart contains the type, amount, and growth rates of capital investment, net operating profit after tax (NOPAT), return on average operating capital, and "economic profit" (NOPAT less a capital charge based on the cost of capital). To create shareholder value, the goal is to determine the extent to which a division's return on total capital (ROTC) exceeds Emerson's cost of capital. Use of the cost of capital rate (Line 3000 on **Exhibit 1**) is required in all division plans.

The next two exhibits contain sales data. The "Sales Gap Chart" and "Sales Gap Line Chart" show the current year's expected sales (1994) and five-year sales projections (1995-1999). See **Exhibits 2** and **3**. These are based on an analysis of sources of growth, the market's natural growth rate, market penetration, price changes,

new products, product line extensions, and international growth. The "gap" represents the difference between the division's long-range sales forecast and top management's target rate for sales growth (Line 19 in **Exhibit 2**). Exhibit 2 shows the five-year sources of sales growth in Column H. These are illustrated in the Sales Gap Line Chart in Exhibit 3 for one of the divisions for the 1995-99 periods. The division president must explain what specific steps are being taken to close the gap.

The "5-Back by 5-Forward P&L in **Exhibit 4** contrasts detailed division data for the current year (1994) with five prior years of historical data and five years of forecast data (1995-99). This comprises 11 years of profit statements including sales; cost of sales; selling, general and administrative expenses; interest; taxes; and return on total capital (ROTC). This statement is used to detect trends. Division management must be prepared with actions to reverse unfavorable movements or trends.

Beyond the review and discussion of the four required exhibits, the division planning conference belongs to the division president. Top management listens to division management's view of customers, markets, plans for new products, analyses of competition, and reviews of cost reductions, quality, capacity, productivity, inventory levels, and compensation. Any resulting changes in the division plan must be submitted for approval by top management. The logic and underlying assumptions of the plan are challenged so that managers who are confident of their strategies can defend their proposals. CEO Knight views the test of a good planning conference is whether it results in manager actions that significantly impact the business. According to Knight:

Since operating managers carry out the planning, we effectively establish ownership and eliminate the artificial distinction between strategic and operating decisions. Managers on the line do not-and must never-delegate the understanding of the business. To

develop a plan, operating managers work together for months. They often tell me that the greatest value of the planning cycle lies in the teamwork and discipline that the preparation phase requires.<sup>2</sup>

Late in the fiscal year, the division president and appropriate division staff meet with top management to present a detailed forecast for the coming year and conduct a financial review of the current year's actual performance versus forecast. The forecast is expected to match the data in the plan resulting from the division planning conference, but top management also requests contingency plans for several lower levels of activity. A thorough set of actions to protect profitability at lower sales levels is presented. These are known as contingency plans. Changes to the division's forecast are not likely unless significant changes occurred in the environment or in the underlying assumptions. Top management must approve changes in the forecast. It is not Emerson's practice to aggregate financial reports for planning and controlling profits between the division and corporation as a whole.

In August, the information generated for and during the division planning conferences and financial reviews is consolidated and reviewed at corporate headquarters by top management. The objective is to examine the total data and prepare for a corporate wide planning conference. In September, before the start of the next fiscal year, top management and top officers of each division attend an annual corporate planning conference. At this meeting, top management presents the corporate and division forecasts for the next year as well as the strategic plan for the next five years. The conference is viewed as a vehicle for communication. There is open and frank discussion of success stories, missed opportunities, and future challenges.

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<sup>2</sup> Knight, p. 63.

## REPORTING

At its meetings the CEO uses the President's Operating Report (POR) to review division performance. Each division president submits the POR (see **Exhibit 5**), on a monthly basis. This reporting system is different from budget reports found in other companies.

First, the POR contains three columns of data for the "current year." The third column of data (Forecast) reflects the plan agreed to by the division president and top corporate management at the beginning of the fiscal year. The forecast data is not changed during the fiscal year and the division president's performance is measured using the fiscal year's forecast. The first column reports the actual results for completed quarters or expected amounts for the current and future quarters. The division president may update expected quarterly results each month. The second column reports the "prior expected" results so that each month's updated expectations can be compared with data submitted in the prior month's POR. Updated expectations are also compared with the forecast data.

Second, in addition to current year data, the POR lists the prior year's actual results. This permits a comparison with the current year's actual results for completed quarters (or expected results for subsequent quarters) and over (O) or under (U) percentages are reported. Midway through the fiscal year, expected data for the first quarter of the next fiscal year is added to the POR.

Corporate top management meets quarterly with each division president and his or her chief financial officer to review the most recent POR and monitor overall division performance. The meetings are taken very seriously by all concerned and any deviations from forecast get close attention. When a division's reported results and expectations are weak, a shift to contingency plans is sometimes ordered by top management; Emerson does not allocate corporate overhead to the divisions but does allocate interest and taxes to divisions at the end of the fiscal year.

## COMPENSATION

During the year, each division assesses all department heads and higher-level managers against specific performance criteria. Those with high potential are offered a series of assignments to develop their skills. Human resources are identified as part of the strategy implementation. In addition, personnel charts on management team are kept at corporate headquarters. The charts include each manager's photo, function, experience, and career path. About 85 percent of promotions involve internal managers.

Each executive in a division earns a base salary and is eligible for "extra salary," based on division performance according to measurable objectives (primarily sales, profits, and return on capital). An extra salary amount, established at the beginning of the year, is multiplied by "1" if the division hits targeted performance. The multiplier ranges from .35 to 2.0. Doing better than target increases the multiplier. In recent years, sales and profit margin, as identified in the POR forecast column, have had a 50 percent weighting in computing compensation targets. Other factors include inventory turnover, international sales, new product introductions, and an accounts receivable factor. In addition, stock options and a five-year performance share plan are available to top executives.

## COMMUNICATION

Top management strongly encourages open communication. Division presidents and plant managers meet regularly with all employees to discuss the specifics of the business and the competition. As a measure of communication, top management feels that each employee should be able to answer four essential questions about his or her job:

1. What cost reduction are you currently working on?
2. Who is the competition?
3. Have you met with your management in the past six months?
4. Do you understand the economics of your job?

The company also conducts opinion surveys of every employee. The analysis uncovers trends. Some plants have survey data for the prior twenty years. The CEO receives a summary of every opinion survey from every plant.

## RECENT EVENTS

As a result of a \$2 billion investment in technology during the past 10 years, new products as a percent of sales increased from 13 percent in 1983 to 24 percent in 1993. A new product is defined as a product introduced within the past five years. About 87 percent of total U.S. sales are generated from products that are either first or second in domestic position. Still, some in the investment community do not view Emerson as a technology leader, but as a very efficient world-class manufacturer. Although internally generated new products are part of the planning process, Emerson is sometimes a late entrant in the marketplace. For example, in 1989, a competitor introduced a low-cost, hand-held ultra-sonic gauge. Within 72 days, Emerson introduced its own version at 20 percent less cost than its competitor's gauge. Emerson's gauge was also easier to use and more reliable. It was a bestseller within a year.

To some Wall Street observers, it seems that Emerson is attempting to reduce its dependence on supplying commodity-type products, such as motors and valves, to U.S. based appliance and other consumer-durables manufacturers by moving into faster growing global markets, such as process controls. As the economy recovers, Emerson is likely to continue its acquisition strategy, with an emphasis on foreign acquisitions, and international joint ventures.

The impact of the recent business segment organization structure on the planning and control process is not clear. The added layer of management between the division managers and top management might change the previous relationship between them.

## QUESTIONS

1. Evaluate Chief Executive Officer Knight's strategy for the Emerson Electric Company.

In view of the strategy, evaluate the planning and control system described in the case. What are its strong and weak points?

2. What role should the eight business segment managers have in Emerson's planning and control system?

**EXHIBIT 1 The Value Measurement Chart Assesses Value**

	Line No.	5th Prior Year		Current Year	
		Actual FY 1989		Expected FY 1994	
		Amt.	% Sales	Amt.	% Sales
<b>Growth Rate and Capital Requirements</b>					
Working capital operating-Y/E	1127	117.1	29.8%	120.2	21.8
Net noncurrent assets-Y/E	1128	92.9	23.8%	150.0	27.2
Total operating capital-Y/E	1129	210.0	53.4%	270.2	48.9
Average operating capital	1130	201.1	51.1%	267.1	48.4
Incremental investment	1584				
Net oper. prof. aft. tax (NOPAT)	1119	33.4		49.5	
Return on incremental investment					
NOPAT growth rate					
Capital growth rate					
<b>Rate of Return</b>					
Return on total capital = $\frac{\text{NOPAT}}{\text{Avg. oper. cap.}}$			16.6%		18.5%
Net sales	0001	393.2		552.2	
Sales growth rate					
NOPAT margin			8.5%		9.0%
Operating capital turnover (T/O)			1.96		2.07
Cost of capital	3000		12.0%		12.0%
Capital charge (L1130 X L3000)	3001	24.1		32.1	
Economic profit (L1119-L3001)			9.3		17.4

\*In millions of dollars (all numbers in the exhibit are disguised).

Source: Charles F. Knight, "Emerson Electric: Consistent Profits, Consistently," *Harvard Business Review*, Vol. 62, No. 1, 1984. All numbers are disguised.

**EXHIBIT 2 The Sales Gap Chart Forecasts Five-Year Plans\***

Line No.	Prior Year Actual FY 93	Forecast										5-Year Source of Growth (%)	5-Year Company Annual Growth (%)	
		A	B	C	D	E	F	G	H	I				
<b>Domestic Excluding Exports</b>														
1		305.7	305.7	305.7	305.7	305.7	305.7	305.7	305.7	305.7	305.7	305.7		
2			3.0	24.6		39.0	49.6	58.3					21.1%	3.6%
3			6.3	14.1		21.0	29.8	37.5					13.6	2.0
4			3.3	7.6		14.7	29.5	38.0					12.6	1.7
5		16.1	16.4	17.7		17.4	17.5	19.0					1.1	
6		1.4	5.6	11.6		18.5	25.9	34.2					11.9	
7		3.1	1.4	1.6		2.3	2.5	2.8					-0.1	
8	363.7	329.6	346.0	390.0		425.5	460.5	495.6						8.5
<b>International Excluding Sales to U.S.</b>														
9		202.9	202.9	202.9	202.9	202.9	202.9	202.9	202.9	202.9	202.9	202.9		
10			(0.1)	8.8		17.0	24.8	35.4					12.9	3.3
11			(0.5)	18.8		27.2	36.2	45.1					16.4	3.6
12		2.0	4.9	8.5		12.5	16.9	21.7					7.1	1.4
13		6.9	7.1	6.7		7.1	8.0	9.2					0.8	
14		1.1	4.5	6.3		10.1	14.3	16.9					5.7	

**Exhibit 2 The Sales Gap Chart Forecasts Five-Year Plans\* (continued)**

Line No.	Prior Year Actual FY 93	Current Year Expected FY 94	Forecast							5-Year Source of Growth (%)	5-Year Company Annual Growth (%)			
			A	B	C	D	E	F	G			H	I	
15		9.3												
16		0.4	0.8	0.7	0.9	1.0	1.1							
17	204.3	222.6	219.6	252.7	277.7	304.1	332.3							8.3
18	568.0	552.2	565.6	642.7	703.2	764.6	827.9							8.4
		-2.8%	2.4%	13.6%	9.4%	8.7%	8.3%							
19														
20			635.0	730.2	839.8	965.7	1,110.6							15.0
21	35.3	31.3	33.7	36.9	39.9	43.9	47.6							8.7
22	169.1	191.4	185.8	216.8	237.8	260.3	284.7							6.3

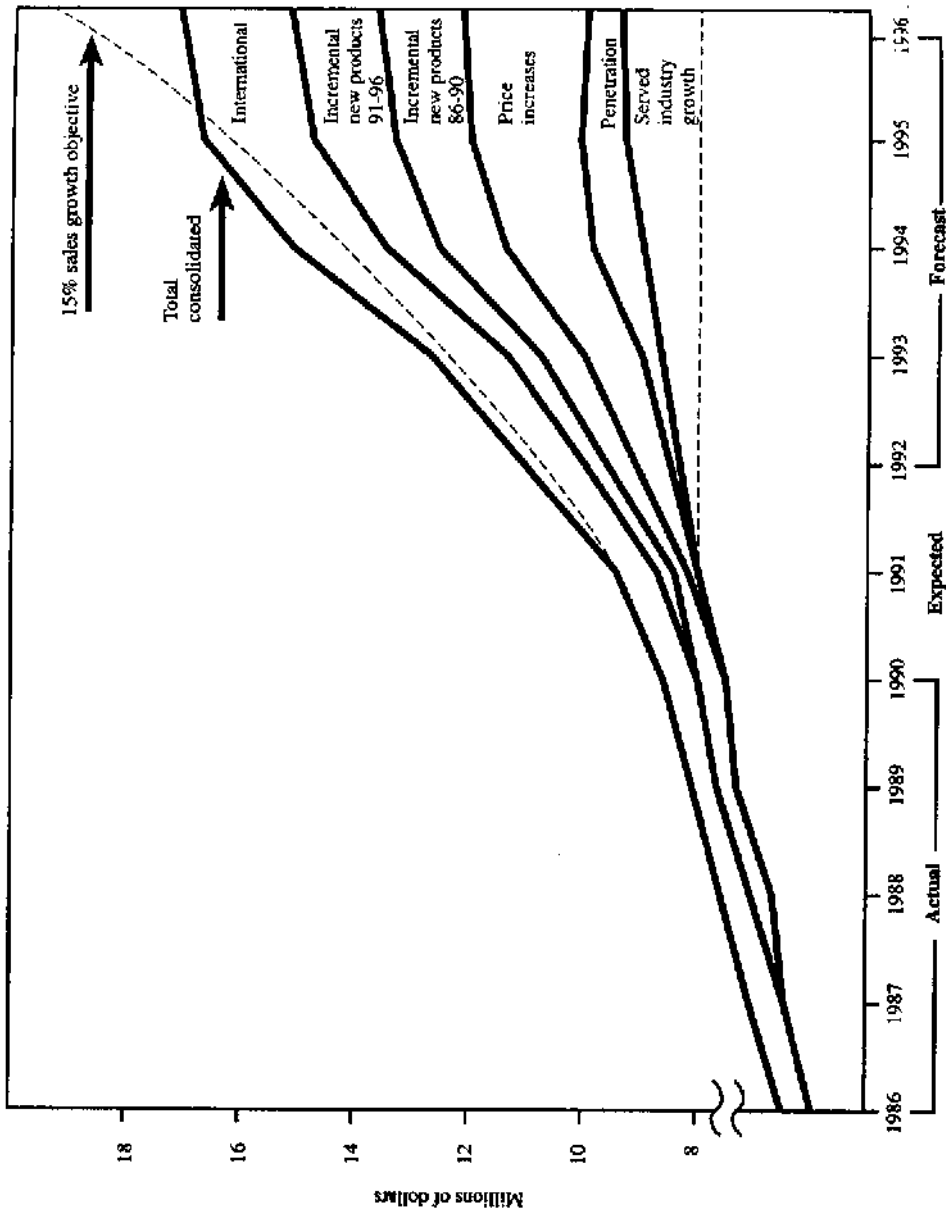
\*In millions of dollars (all numbers in the exhibit are disguised).

Source: Charles F. Knight, "Emerson Electric: Consistent Profits, Consistently," *Harvard Business Review*, January-February 1982, p. 64. Used with permission of the Emerson Electric Company.



**EXHIBIT 3**

*The sales gap line chart projects sales growth against other targets*



Note: All numbers in the exhibit are disguised.

Source: Charles F. Knight, "Emerson Electric: Consistent Profits, Consistently," *Harvard Business Review*, January-February 1992, p. 68. Used with permission of the Emerson Electric Company.

**EXHIBIT 4 The 5-Back-by-5-Forward Chart Provides 11 Years of P&L Measures\***

Line No.	Actual/Restated										Current Year					Forecast				
	5th FY	4th FY	3rd FY	2nd FY	Prior Year		Expected	Next Yr	2nd Yr	3rd Yr	4th Yr	5th Yr	3rd Yr	4th Yr	5th Yr					
	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94	FY 95	FY 96	FY 96	FY 97	FY 98	FY 99								
Order entries	1143	71,363	77,057	92,716	100,164	126,591	128,247	142,612	157,972	173,743	189,856	207,133								
Sales backlog (year end)	1144	13,310	14,051	17,098	16,534	29,334	29,842	31,509	33,082	34,805	36,591	38,363								
Net sales	0001	71,163	76,316	89,669	100,728	113,791	127,739	140,945	156,399	172,020	188,070	205,361								
Annual growth %-nominal			7.2%	17.5%	12.3%	13.0%	12.3%	10.3%	11.0%	10.0%	9.3%	9.2%								
-real							11.3%	7.8%	8.4%	6.7%	6.8%	6.1%								
Cost of sales	0009	36,802	39,382	46,487	51,593	60,003	67,651	74,432	82,109	89,966	98,173	106,997								
% to sales		51.7%	51.6%	51.8%	51.2%	52.7%	53.0%	52.8%	52.5%	52.3%	52.2%	52.1%								
Gross profit	0010	34,361	36,934	43,182	49,135	53,788	60,088	66,513	74,290	82,054	89,897	98,364								
% to sales		48.3%	48.4%	48.2%	48.8%	47.3%	47.0%	47.2%	47.5%	47.7%	47.8%	47.9%								
SG&A expenses	0011	21,773	22,558	26,246	29,941	32,163	36,150	40,169	44,887	49,714	54,366	59,555								
% to sales		30.6%	29.6%	29.3%	29.7%	28.3%	28.3%	28.5%	28.7%	28.9%	28.9%	29.0%								
Operating profit	0012	12,588	14,376	16,936	19,194	21,625	23,938	26,344	29,403	32,310	35,531	38,809								
% to sales		17.7%	18.8%	18.9%	19.1%	19.0%	18.7%	18.7%	18.8%	18.8%	18.9%	18.9%								
Other (inc./ded. (excl. int.))	0235	423	1,090	1,395	1,232	1,488	1,764	1,766	1,794	1,530	1,438	1,423								
Earnings before interest & taxes	0240	12,165	13,286	15,541	17,962	20,137	22,174	24,578	27,609	30,810	34,093	37,386								
% to sales		17.1%	17.4%	17.3%	17.8%	17.7%	17.4%	17.4%	17.7%	17.9%	18.1%	18.2%								

**Exhibit 4 The 5-Back-by-5-Forward Chart Provides 11 Years of P&L Measures\* (continued)**

Line No.	Actual/Restated					Current Year					Forecast						
	5th FY	4th FY	3rd FY	2nd FY	Prior Year	Expected FY 94	Next Yr FY 95	2nd Yr FY 96	3rd Yr FY 97	4th Yr FY 98	5th Yr FY 99	Expected FY 94	Next Yr FY 95	2nd Yr FY 96	3rd Yr FY 97	4th Yr FY 98	5th Yr FY 99
	A	B	C	D	E	F	G	H	I	J	K	F	G	H	I	J	K
Interest (income)/expense, net	0230	(771)	(1,041)	(1,127)	(1,326)	(1,781)	(2,324)	(2,576)	(2,734)	(2,903)	(3,070)	(2,324)	(2,330)	(2,576)	(2,734)	(2,903)	(3,070)
Pretax earnings	0015	12,986	14,327	16,668	19,288	21,918	24,398	30,185	33,544	36,996	40,456	24,398	26,908	30,185	33,544	36,996	40,456
% to sales		18.2%	18.8%	18.6%	19.1%	19.3%	19.1%	19.3%	19.5%	19.7%	19.7%	19.1%	19.1%	19.3%	19.5%	19.7%	19.7%
Income taxes	0016	5,445	6,785	7,788	8,447	9,668	10,551	13,101	14,497	15,948	17,387	10,551	11,753	13,101	14,497	15,948	17,387
Effective tax rate		42.1%	47.4%	46.7%	43.8%	44.1%	43.2%	43.4%	43.2%	43.1%	43.0%	43.2%	43.7%	43.4%	43.2%	43.1%	43.0%
Net earnings	0017	7,491	7,542	8,880	10,841	12,250	13,847	17,084	19,047	21,048	23,069	13,847	15,155	17,084	19,047	21,048	23,069
% to sales		10.5%	9.9%	9.9%	10.8%	10.8%	10.8%	10.9%	11.1%	11.2%	11.2%	10.8%	10.8%	10.9%	11.1%	11.2%	11.2%
Return on total capital	1324	20.4%	19.7%	20.3%	23.6%	23.8%	25.1%	28.0%	30.1%	32.0%	33.9%	25.1%	26.1%	28.0%	30.1%	32.0%	33.9%
ROTC excluding goodwill	1323	27.3%	28.0%	27.2%	30.6%	31.5%	32.5%	34.7%	36.6%	38.3%	40.2%	32.5%	32.9%	34.7%	36.6%	38.3%	40.2%

\*In thousands of dollars (all numbers in the exhibit are disguised).

Source: Charles F. Knight, "Emerson Electric: Consistent Profits, Consistently," *Harvard Business Review*, January-February 1992, p. 66. Used with permission of the Emerson Electric Company.

**EXHIBIT 5 President's Operating Report Division—Fiscal Year by Quarters/Actual and Expected**

Line No.	(Thousands of Dollars)											% Act/Exp O/(U) PY
	Current Year						Forecast			Prior Year		
	Actual/Expected	% Sales	Prior Expected	% Sales	Forecast	% Sales	Actual	% Sales	Actual	% Sales		
<b>1st Quarter Ending December 31</b>												
1	Intercompany Sales	36		36		34		37				-2.7%
2	Net Sales	29,613		29,613		29,463		25,932				14.2%
3	Gross Profit	14,065	47.5%	14,065	47.5%	13,790	46.8%	12,384	47.8%			13.6%
4	SG&A Expenses	8,312	28.1%	8,312	28.1%	8,281	28.1%	7,650	29.5%			8.7%
5	Operating Profit	5,753	19.4%	5,753	19.4%	5,509	18.7%	4,734	18.3%			21.5%
6	Earnings Before Interest & Tax	5,280	17.8%	5,280	17.8%	5,048	17.1%	4,343	16.7%			21.6%
<b>2nd Quarter Ending March 31</b>												
7	Intercompany Sales	5		5		9		56				-91.1%
8	Net Sales	33,324		33,324		31,765		22,661				25.0%
9	Gross Profit	15,283	45.9%	15,283	45.9%	14,812	46.6%	12,518	47.0%			22.1%
10	SG&A Expenses	9,301	27.9%	9,301	27.9%	8,937	28.1%	7,395	27.8%			25.8%
11	Operating Profit	5,982	18.0%	5,982	18.0%	5,875	18.5%	5,123	19.2%			16.8%
12	Earnings Before Interest & Tax	5,785	17.4%	5,785	17.4%	5,612	17.7%	4,918	18.4%			17.6%
<b>3rd Quarter Ending June 30</b>												
13	Intercompany Sales	25		25		39		146				-82.9%
14	Net Sales	32,845		32,845		33,424		30,578				7.1%
15	Gross Profit	15,353	46.7%	15,353	46.7%	15,064	46.9%	14,310	46.6%			7.3%
16	SG&A Expenses	8,916	27.1%	8,916	27.1%	9,399	28.2%	8,424	27.4%			5.8%
17	Operating Profit	6,437	19.6%	6,437	19.6%	6,265	18.7%	5,886	19.2%			9.4%
18	Earnings Before Interest & Tax	6,126	18.7%	6,126	18.7%	5,645	16.9%	5,378	17.5%			13.9%
<b>4th Quarter Ending September 30</b>												
19	Intercompany Sales	94		94		94		25				276.0%
20	Net Sales	36,611		36,611		35,722		30,521				20.0%
21	Gross Profit	17,109	46.7%	17,109	46.7%	16,832	47.1%	14,676	47.9%			17.4%

**Exhibit 5 President's Operating Report Division—Fiscal Year by Quarters/Actual and Expected (continued)**

Line No.	(Thousands of Dollars)										% Act/ Exp O/(I) PY
	Current Year					Prior Year					
	Actual/ Expected	% Sales	Prior Expected	% Sales	Forecast	% Sales	Actual	% Sales	Actual	% Sales	
22	SG&A Expenses	10,537	28.7%	10,537	28.7%	10,029	28.1%	8,695	28.5%	21.2%	
23	Operating Profit	6,572	18.0%	6,572	18.0%	6,803	19.0%	5,881	19.3%	11.7%	
24	Earnings Before Interest & Tax	6,122	16.7%	6,122	16.7%	8,146	22.8%	5,498	18.0%	11.3%	
<b>Fiscal Year Ending September 30</b>											
25	Intercompany Sales	160		160		176		264		-39.4%	
26	Net Sales	132,393		132,393		130,374		113,792		16.3%	
27	Gross Profit	61,810	46.7%	61,810	46.7%	61,098	46.9%	53,788	47.3%	14.9%	
28	SG&A Expenses	37,066	28.0%	37,066	28.0%	36,646	28.1%	32,164	28.3%	15.2%	
29	Operating Profit	24,744	18.7%	24,744	18.7%	24,452	18.8%	21,624	19.0%	14.4%	
30	Earnings Before Interest & Tax	23,313	17.6%	23,313	17.6%	24,451	18.8%	20,137	17.7%	15.8%	
31	Pre-Tax Earnings	25,154	19.0%	25,154	19.0%	24,771	19.0%	21,918	19.3%	14.8%	
32	Net Earnings	14,361	10.8%	14,361	10.8%	14,024	10.8%	12,250	10.8%	17.2%	
<b>Expected First Quarter Next Fiscal Year</b>											
33	Intercompany Sales	67		65				36		86.1%	
34	Net Sales	32,830		32,311				29,613		10.9%	
35	Gross Profit	15,142	46.1%	15,143	46.9%			14,065	47.5%	7.7%	
36	SG&A Expenses	9,179	27.9%	9,217	28.6%			8,312	28.1%	10.4%	
37	Operating Profit	5,963	18.2%	5,925	18.3%			6,753	19.4%	3.7%	
38	Earnings Before Interest & Tax	5,628	17.1%	5,619	17.4%			5,280	17.8%	6.6%	

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## Case 10-2: LetsGo Travel Trailers

LetsGo manufactures travel trailers bought primarily by young families and retirees interested in a light, low-cost trailer that can easily be pulled by a mid-sized family car. The market for travel trailers has expanded nicely over the past few years due to the number of families seeking a relatively low-cost, outdoor vacation experience. But in the view of LetsGo's president, Mark Newman, the real growth in the future is in the retiree market. Newman believes the vigorous health of the average retiree, couple with the national trend toward a return to nature, will translate into continuing sales growth for LetsGo. As Newman loves to say, "camping recently moved from number seven to number six on the top-10 leisure activities in the United States, and the baby boomers are getting older every day."

### The Retiree Market

Baby boomers (born between 1/1/46 and 12/31/64) carry a lot of consumer clout. Research indicates that for an organization to meet the needs of the senior market, including baby boomers, the following must be addressed:

- Independence and control
- Intellectual stimulation and self-expression
- Security and peace of mind
- Quality and value

According to the National Opinion Research Center at the University of Chicago, 78% of boomers (aged 33-51) own their own home, 45% are satisfied with their financial situation, 67% have not been hospitalized in the past five years, 73% are married, and 69% of their households have two wage earners. By the year 2000, boomers are expected to have an estimated \$1 trillion to spend.<sup>1</sup> By 2010, the United States will be home to 53 million people aged 55 or older, with eight states expected to double their elderly population: Alaska, Arizona, California, Colorado, Georgia, Nevada, Utah, and Washington. Seniors respond to benefit-driven messages; to attract them, advertising has to communicate tangible benefits rather than features and amenities.

### Marketing and Sales

The forecasted increase in Letsgo's sales can be seen in the company's sales projections presented in Exhibit 1 (actual for the years 1992 through 1997 and projected for the years 1998 through 2002). Although the weather can have a significant impact on the travel trailer industry (i.e., hurricane season, flooding, and even droughts have had negative effects on the sales and rentals of travel trailers), Letsgo's management believes these problems will be mitigated in the future by global warming. All sales projections are done by Mark Newman in his role as Letsgo's president.

To keep from losing sales, the company maintains finished goods inventory on hand at the end of each month equal to 300 trailers plus 20% of the next month's projected sales. The finished goods inventory on 12/31/97 was budgeted to be 1,000 trailers. Jim West, Letsgo's vice-president of marketing, would rather see a minimum finished goods inventory of at least 1,500 trailers. Jim refuses to talk to Tom Sloan, the production manager. Tom is always trying to get Jim to consider adopting flexible inventory levels, which Jim is certain would affect his yearly bonus. The vice-president of marketing is eligible for a 20% bonus based on sales. Unfortunately, Jim did not receive a bonus in 1997. Sales were up, but Mark refused to

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<sup>1</sup>Note that this case was published in 1997.

give Jim the bonus, although it was earned, due to the high number of customer complaints. Jim was really steamed when he heard “no bonus.” Didn’t Mark know those complaints were for poor quality? All of Jim’s efforts to grow sales and attract customers were, once again, destroyed by Tom Sloan and his production failures.

## Trailer Production

Sheet aluminum represents the company’s single most expensive raw material. Each travel trailer requires 30 square yards of sheet aluminum. The wholesale cost of sheet aluminum varies dramatically by time of year. The cost per square yard can vary from \$13 in the Spring, when new construction tends to start, to \$6 in December and January, when demand is lowest. In September 1997, the Department of Energy and the aluminum industry launched a collaboration to pursue technologies to improve energy efficiency and production processes. “The pact will increase global competitiveness and enhance the environmental performances of a key manufacturing sector by applying advanced scientific know-how to day-to-day industry needs” (Secretary of Energy Hazel R. O’Leary, September 1997). This collaboration will increase the aluminum industry’s competitiveness and thus help businesses that rely on aluminum to reduce costs. Manufacturers requiring aluminum as a raw material potentially should be able to negotiate better purchase prices from suppliers.

Aluminum promises to be the construction material of the future. The use of aluminum in vehicles is increasing rapidly due to a heightened need for fuel-efficient, environmentally friendly vehicles. Aluminum can provide a weight savings of up to 55% compared to a steel structure, improving gas mileage significantly. The aluminum industry and suppliers are dispersed across four-fifths of the country, yet they are largely concentrated in four regions: the Pacific Northwest, industrial Midwest, northeastern seaboard, and mid-South. Although this is a broad geographic presence, Letsgo Travel Trailers will be affected by distribution costs.

Vicky Draper, Letsgo’s vice-president of purchasing and materials handling, is eager to implement just-in-time (JIT) as a way of lowering Letsgo’s aluminum cost, to offset the expense of distribution--Letsgo is located in Pennsylvania. Vicky’s projected 20% bonus, recently announced by Mark and effect for the year-end 1998, is based on her ability to lower total material costs. Initially enthusiastic about her job and ability to earn a significant bonus, Vicky has become discouraged and angry. She is unable to convince Letsgo’s current aluminum supplier to sign a prime vendor contract, and her efforts to locate an alternative vendor willing to accept the conditions of a JIT contract have similarly failed. She blames Tom Sloan. Letsgo’s current aluminum vendor refuses to sign a JIT prime vendor contract due to Tom’s uneven production schedule and his refusal to pay on time. Tom has been seen reading the Help Wanted ads, and Vicky overheard him talking to an employment agency.

In keeping with the policy set by Tom as Letsgo’s production manager, the amount of sheet aluminum on hand at the end of each month must be equal to one-half of the following month’s production needs for sheet aluminum. The raw materials inventory on December 31, 1997, was budgeted to be 39,000 square yards. The company does not keep track of work-in-process (WIP) inventories. Total budgeted merchandise purchases (of which the sheet aluminum is a significant part) and budgeted expenses for wages, heat, light and power, equipment rental, equipment purchases, depreciation, and selling and administrative for the first six months of 1998 are given below:

	<i>January</i>	<i>February</i>	<i>March</i>
Merchandise purchases	\$870,000	\$1,320,000	\$1,110,000
Wages	624,000	1,008,000	1,104,000
Heat, light, & power	130,000	195,000	220,000
Equipment rental	390,000	390,000	390,000

Equipment purchases	300,000	300,000	300,000
Depreciation	250,000	250,000	250,000
Selling & administrative	400,000	400,000	400,000

	<i>April</i>	<i>May</i>	<i>June</i>
Merchandise purchases	\$690,000	\$420,000	\$330,000
Wages	672,000	432,000	240,000
Heat, light, & power	135,000	110,000	110,000
Equipment rental	340,000	340,000	340,000
Equipment purchases	300,000	300,000	300,000
Depreciation	275,000	275,000	275,000
Selling & administrative	400,000	400,000	400,000

Merchandise purchases are paid in full during the month following purchase. Accounts payable for merchandise purchases on December 31, 1997, which will be paid during January, total \$850,000.

## **Competition**

All forms of vacation and leisure activities, including theme parks, beach or cabin rentals, health spas, resorts, and cruise vacations compete with Letsgo Travel Trailers for the consumer dollar. Other recreational purchases such as automobiles, snowmobiles, boats, and jet-skis are indirect competitors.

Travel trailer manufacturers such as Rexhall Industries, Coachman Industries, Winnebago Industries, Foremost Corporation of America, and Thor Sales Industries also offer a moderate-to-low-priced trailer. Manufacturers that offer more diverse product lines such as high-end trailers with luxury accommodations could compete for the fairly affluent senior market.

Coachman Industries, a direct Letsgo competitor, has become a leader in the recreational vehicle, motor home, and travel trailer industry through a commitment to quality and value based on excellence in engineering and attention to detail. Creative engineering, combined with high-accuracy analysis, reduced material costs at Coachman by more than 60% and labor costs by 78%.

## **Budget Preparation**

To minimize company time lost on clerical work, Letsgo's accounting department prepares and distributes all budgets to the various departments every six months. Per Mark Newman, "Freeing departmental managers from the budgeting process allows them to concentrate on more pressing matters." In keeping with the recently announced bonus plan for the vice-president of purchasing and materials handling, Newman has instructed the accounting department to budget aluminum at \$6 per square foot. The accounting manager recently received a 20% bonus for having prepared the budgets on time with little or no help from the other functional areas.

## **Cash**

Letsgo's vice-president of finance, Becky Newman, has requested an \$800,000, 90-day loan from the bank at a yet-to-be-determined interest rate. Since Letsgo has experienced difficulty in paying off its loans in the past, the loan officer at the bank has asked the company to prepare a cash budget for the six months ending June 30, 1998, to support the requested loan amount. The cash balance on January 1, 1998, is budgeted at \$100,000 (the minimum cash balance required by Letsgo's Board of Directors).



## Human Resources

To accomplish the company's corporate strategic goals, Letsgo Travel Trailers encourages upward communication among all its employees, from senior management to line employees. Decision-making, although not an entirely democratic process, is based on a team approach. Newman, as Letsgo's president, encourages managers to think in terms of the marketplace and to look at the business of travel trailers as a whole rather than as functional department successes and decisions. In fact, Newman is so committed to the idea of cooperative management and teamwork that he has hired three separate human resource consultants in the past six months to lead the company's managers through team-building exercises.

### Required

1. Discuss the validity and reasonableness of Letsgo's sales projections.
  
2. Prepare production, purchasing, and cash budgets for Letsgo for the first six months of 1998. Discuss the advantages and disadvantages of the budgets you prepared. Who in the company does the budget help and whom, potentially, does it hurt? Does the budget help or hurt the sales department? What about production and finance? How are the various functional areas affected, and why?
  
3. Andy Baxter, newly hired by Letsgo from a competitor, suggests preparing the production budget assuming stable production. Prepare a second and third set of production, material purchases, and cash budgets with production held constant at 3,000 trailers per month for the second set of budgets and 3,500 trailers per month for the third set of budgets, using the following approach for the production budget (the purchasing and cash budget formats remain as presented above in question (2))--note: please see the tabs at the bottom of the spreadsheet template included as part of this case.

	Jan	Feb	March	April	May	June	Six-Month Total
Production	3,000	3,000	3,000	3,000	3,000	3,000	18,000
Add: Beg inventory							
Total Available							
Less: Est. sales							
Ending inventory							

**Assumptions:** You will have to make some assumptions in order to complete the materials purchases (and cash payments) budget and for the budget for wages (labor) expense.

- (1) Assume that the labor cost per unit produced = average wage cost per unit, January - June in the original data set. As before, assume that wages are paid in the month incurred.
  
- (2) In terms of materials, note that the total amount purchased each month = purchases of aluminum (sheet metal) + purchases of other materials. As before, assume that all purchases are paid in the month following the month of purchase (i.e., there is a one-month payment lag). Assume that the beginning-of-year balance for total purchases payable is \$850,000 (the same as before). To estimate total purchases PAYMENTS in a given month, use the following percentage obtained from the original data, any of the months March through June:  $\text{Total Purchases}_t / \text{Aluminum Purchases}_{t-1}$ . (**Hint:** this number should be 166.67%.) Assume that the ALUMINUM purchases (from January) to be paid in February = \$711,000 (same as before). This amount will have to be increased by estimated non-Aluminum materials purchased using the preceding rate.

Discuss the advantages and disadvantages of the second and third sets of production, material purchases, and cash budgets you've prepared. Who in the company do these budgets help and whom, potentially, do they hurt? Do these budgets help or hurt the sales department? What about production and finance? How are the various functional areas affected, and why?

4. What should Letsgo use to measure performance for each of the managers in the case? What bonus system would you suggest that incorporates these measures and also encourages the managers to work as a team?

**Exhibit 1**  
**Actual and Projected Sales, in Number of Trailers**

	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>
Actual sales	13,765	14,880	15,991	17,809	19,634	23,322
	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	
Projected sales	28,000	33,600	40,320	48,384	58,060	

The sales details for 1997 (actual) and 1998 (projected), by month, are as follows:

	<b>1997</b>	<b>1998</b>
	<u>Actual</u>	<u>Projected</u>
January	1,983	2,500
February	3,218	4,000
March	3,981	5,000
April	3,240	3,000
May	1,755	2,000
June	901	1,000
July	763	1,000
August	611	1,000
September	1,622	2,000
October	1,678	2,000
November	1,439	2,000
December	<u>2,131</u>	<u>2,500</u>
Total no. of trailers	<u>23,322</u>	<u>28,000</u>

Actual sales in dollars for the last two months of 1997 and budgeted sales for the first six months of 1998 follow:

November 1997 (actual)	\$1,439,000
December 1997 (actual)	2,131,000
January 1998 (budgeted)	2,500,000
February 1998 (budgeted)	4,000,000
March 1998 (budgeted)	5,000,000
April 1998 (budgeted)	3,000,000
May 1998 (budgeted)	2,200,000
June 1998 (budgeted)	1,100,000

Past experience shows that 25% of a month's sales are collected in the month of sale, 10% in the month following the month of sale, and 60% in the second month following the month of sale.

## Reading 10-3: How Challenging Should Profit Budget Targets Be?

by Kenneth A. Merchant

It is a basic axiom of management that budget targets should be set to be challenging but achievable. But to establish that target, managers must first determine what "challenging but achievable" really means. Should profits be targeted at some easily obtainable goal, a realistic middle ground, or at a point so high that hope of attainment is slim?

There is no one right answer, given the number of purposes for which budgets are used: planning, coordination, control, motivation, and performance evaluation. Some may argue that planning purposes are served best with a best-guess budget, one that is as likely to be exceeded as missed. Others may propose that, for optimum motivation, budget targets should be highly challenging, with only a 25% to 40% chance of achievement.

There is one target-level choice, however, that serves the combination of purposes for which budgets are used quite well in the vast majority of organizational situations. Therefore, it provides an effective compromise. That choice is to set budget targets with a high probability of achievement—achievable by most managers 80% to 90% of the time—and then to supplement these targets with promises of extra incentives for performance exceeding the target level. This prescription for the optimal budget target level, which is nearest point A in **Figure 1**, is made assuming that **Figure 1** represents the probability distribution of forthcoming profits for an effective management team working at a consistently high level of effort.

These targets with an 80% to 90% probability of achievement are labeled properly "highly achievable" for most managers, but because of the assumption described in the preceding paragraph, the targets are at least somewhat challenging. They are not "easy." Even talented, experienced profit center managers must work hard and effectively to give themselves a good chance of achieving these targets.

### THE ADVANTAGES OF USING HIGHLY ACHIEVABLE BUDGET TARGETS

Choosing budget targets with such a high probability of achievement provides many advantages to corporation, including the following:

*Managers' commitment to achieve the budget targets is increased.* When targets are set to be highly achievable, the corporation can assess profit center managers high penalties for failing to achieve the targets at least many more years than not. These penalties can include loss of reputation, loss of autonomy, inability to get funding proposals approved, and sometimes even loss of job. Corporations can allow managers few or no excuses for not achieving the targets because the high achievability is designed to protect the managers to considerable circumstances that were unforeseen at the time performance targets were set.

Because profit center managers face the risk of high penalties for performance shortfalls and do not have the safety net of excuses, they become highly committed to achieve their targets. This commitment causes them to prepare their budget forecasts more carefully and to spend more of their time managing rather than inventing excuses to explain their failures.

Firms that switch their budgeting philosophy to using highly achievable targets instead of "stretch" or "best guess" targets note the increase in commitment quite quickly. Comments a profit center manager in a large U.S. chemical corporation which made the switch:

Two years ago, our budgets were just best-effort forecasts. Today they are commitments. There is a vast difference. It's better to run this way. We have discipline. People used to make projections, but they forgot about them until they had to make another projection. Nobody ever came back and slapped their hand. Now people are challenged to put the things in place that are required to make the projections happen. The plans have begun to have credibility. Our spending plans are based on realistic projections.

Conversely, when budget targets are set at highly challenging levels, the danger exists that managers will not be committed to try to achieve their targets. For example, in a small publicly held electronics firm, which until recently had used a stretch target budgeting philosophy, profit center managers had started earning bonuses when their division's reported profit exceeded 60% of the budgeted level. But all too often, the profit

center and corporate budgets were not achieved. In the words of the chief financial officer: "The system had some fudge in it. The managers were still in bonus territory, so they didn't have to worry about meeting the budget. It was like a wish, too easily blown off."

The corporation now has changed to what is known as "minimum performance standard" budget targets and its managers' commitment to these new targets has increased sharply. Since the change, the profit centers have achieved virtually all their budget targets every quarter.

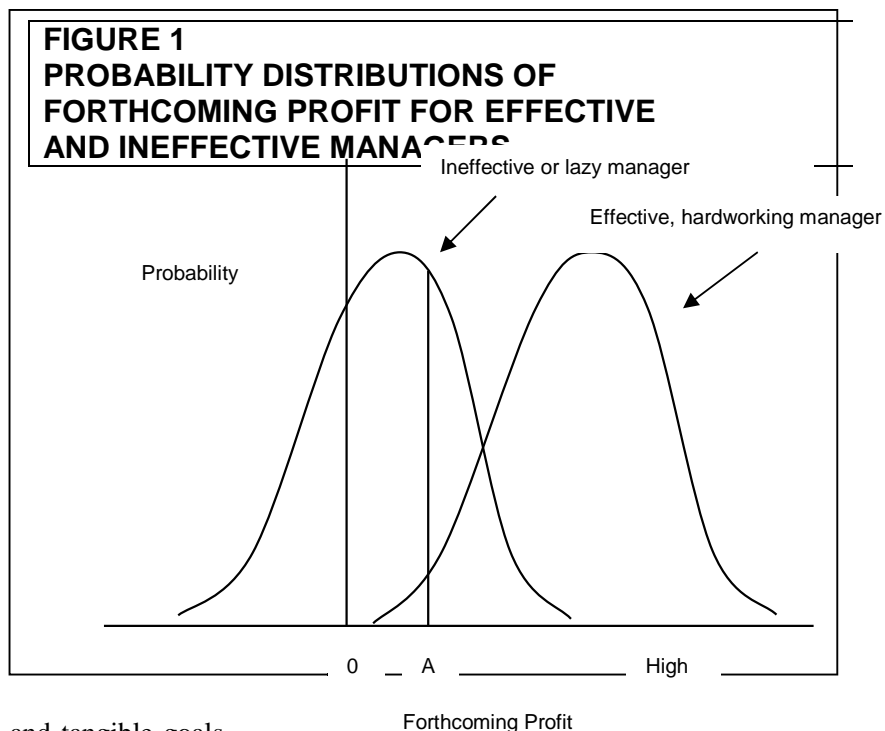
The danger of lack of commitment to achieve targets is particularly acute if something goes wrong early in the year and loss of commitment leads to lower motivation. In the words of a manager whose entity had not achieved its budget targets for several years, "After the first few months of the year, we began to look at our goals as 'pie in the sky.' [The goals] didn't inspire us to do different things. They were just demoralizing. *Managers' confidence remains high.* Regardless of the level of budget achievability, in the minds of most managers budget achievement defines the line between success and failure. Budget targets are the most specific and tangible goals managers are given, and most people define personal success in terms of their high degree of achievement of predetermined targets. As one manager put it, "If I were to miss my budget, I would feel like a failure. When I exceed my budget, I feel proud."

It is to the corporation's advantage to have its managers feel like winners. Managers who feel good about themselves and their abilities are more likely to work harder and to take prudent risks.

*Organizational control costs decrease.* Most corporations use a management-by-exception control philosophy where negative variances from budget signal the need for investigation and perhaps intervention in the affairs of the operating units. If budget targets are set to be highly achievable, negative variances are relatively rare, and top management or staff attention is

directed to the few situations where the operating problems are most likely and most serious.

This point is illustrated in Figure 1. The probability distribution of profit outcomes shifts to the left (lower profit) for a lazy or ineffective manager. What was a highly achievable target for an effective, hardworking manager (point A) is not as highly achievable for an ineffective or lazy manager. Budget misses of two or three years send a strong signal that something is wrong and that top management intervention is necessary.



Budget misses also provide objective rationales for relieving poor managers of their jobs.

*The risk of managers engaging in harmful earnings management practices is reduced.* Managers who are likely to achieve their budget targets are less likely to engage in costly actions designed to boost earnings in the short term. These actions include making potentially risky operating decisions (such as delaying preventative maintenance) and engaging in deceptive accounting practices (such as altering judgments about reserves).

Highly achievable budget targets also lessen the incentives some managers have to reduce current period income. Those individuals who are facing stretch targets they consider nearly impossible to achieve may "take a bath"; they may take costly actions to position their entities for the subsequent accounting period. For

example, they may defer sales and incur as many discretionary expenses as possible in the current period.

*Effective managers are allowed greater operating flexibility.* Highly achievable budget targets allow managers whose entities are performing well to accumulate some slack resources. Most managers will use this slack so that they do not have to respond to unforeseen, unfavorable short-term contingencies in costly ways, such as a suspension of productive long-term investments or a layoff. Some managers also will use the slack in productive, creative ways to fund "skunkworks" that may have high payoffs.

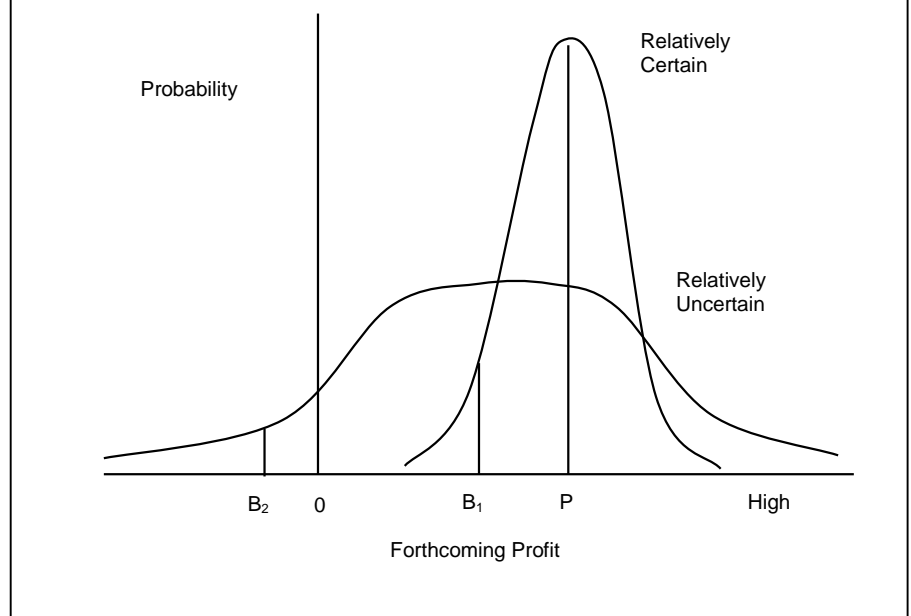
*The corporation is somewhat protected against the costs of optimistic revenue projections.* Budgets with optimistic revenue projections often induce managers to acquire resources in anticipation of activity levels that may not be forthcoming. Some of these resources, particularly people, can be difficult to eliminate when reality sets in. As one corporate president expressed it: "I think we ought to have a semi-aggressive plan, but one that is achievable." We want to make it every year. It's too hard to adjust on the downside, to slough off commitments of expenses or not launch something you're psychologically committed to."

*The predictability of corporate earnings is increased.* When budget targets are likely to be achieved, the consolidated budget provides a highly probably lower bound of forthcoming corporate profits. This earnings predictability is valuable, particularly to managers of publicly held corporations. Earnings are usually less predictable in corporations whose business units face similar business risks, so this earnings-predictability advantage of highly achievable budget targets is higher in undiversified rather than diversified, firms.

### **A RISK IN USING HIGHLY ACHIEVABLE BUDGET TARGETS**

The primary risk in using highly achievable budget targets is that managers may not be challenged to

**FIGURE 2: EFFECT OF PLANNING UNCERTAINTY ON PROBABILITY DISTRIBUTION OF FORTHCOMING PROFIT**



perform at their maximum. They may be satisfied with mediocrity—their levels of aspiration may be too low—and their motivation may slack off after the budgeted profit targets are achieved.

This problem of lack of challenge is potentially more serious when planning uncertainty is relatively high (and the inability to make adjustments for the effects of factors over which the managers had little or no control is relatively low). This is because the distance between the highly achievable target levels and the best-guess (or even higher) target levels is much greater than when planning uncertainty is low. This is shown in Figure 2. The tall curve shows a profit probability distribution in a relatively low uncertainty environment. The highly achievable budget level (B1) is not far from the most likely performance level (P). The shorter, flatter curve shows a distribution in a relatively uncertain environment. In this case, the highly achievable budget level (B2) is far below the most likely performance level.

Even in environments of high uncertainty, however, this lack-of-challenge problem is not inevitable. Most profit center managers have risen through the ranks because they are good performers with strong internal drives for competition and self-satisfaction. Furthermore, the

“winning” feeling generated from budget achievement in prior periods is likely to increase, not decrease, the managers' levels of aspiration.

Furthermore, even when the risk of less than optimal challenge does exist, it can be minimized by giving managers incentives to strive for and to produce profits in excess of their budget targets. These incentives can be provided in combinations of many forms of rewards, including extra bonuses, recognition, autonomy, and command over resources, and increased prospects for career advancement.

Profit center managers also can be asked to turn in more profit than originally was budgeted. This is a common occurrence in U.S. corporations. These orders, combined with the highly achievable original targets, make the budget somewhat flexible. The highly achievable targets protect the profit center managers from the effects of unfavorable influences not explicitly expounded in the budget forecasts. The requests for profits above budgeted levels can be used to adjust for the effects of unforeseen good fortune on the measures of operating results. They can protect the corporation from the negative effects of excessive easy performance targets, such as managers' lagging ambition and the creation of excessive slack.

Only in a few organizational situations is it not desirable to set highly achievable profit budget targets. One exception is caused by organizational need. A company in grave difficulty may want to set less achievable budget targets as a signal to its managers that a certain higher level of performance is necessary for the corporation to survive or for the profit center to stave off divestment.

A second exception occurs when it is desirable to correct for a profit center's windfall gain. Sometimes when managers have been lucky in a prior period, perhaps earning large and mostly undeserved bonuses, a more challenging budget target can be set as an effective way of making compensations more fair across the multiyear period. Here, though, care must be taken to guard against unwarranted management turnover because current period expected compensation probably will fall below competitive market levels.

In virtually all other situations, it is desirable to set highly achievable profit budget targets while allowing the managers few excuses for not achieving the targets. Setting targets that are highly achievable, but not too easy takes considerable managerial skill. Upper-level managers must know enough about the profit centers capabilities and business prospects to be able to judge the probability of budget success reasonably well in order to make this budget philosophy work properly. But when they implement this combination of mechanisms effectively, they will ensure that all the purposes for which budgets are used—planning, coordination, control, motivation, and performance evaluation—are served well.

#### NOTES:

For example, see M. E. Barrett and L. B. Fraser III, "Conflicting Roles in Budgeting for Operations," *Harvard Business Review*, July-August 1977, pp. 137-146.

<sup>2</sup>For example, see R. L. M. Dunbar, "Budgeting for Control," *Administrative Science Quarterly*, March 1971, pp. 88-96.

<sup>3</sup>This finding emerged in a recent intensive study of 12 divisionalized corporations and some related fieldwork. Ten of the 12 corporations participating in the research study had used highly achievable budget targets for some time. One had recently changed its budgeting philosophy. It formerly used "stretch" budget targets but changed to have its targets reflect "minimum performance standards." One firm was still using stretch budget targets, but most of the managers in the firm were recommending that this philosophy of budgeting be changed. (For a detailed report of the findings of this study, see K Merchant, *Rewarding Results: Motivating Profit Center Managers*, Harvard Business School Press, 1989.)

<sup>4</sup>For example, Merchant (1989) found that profit center managers in seven of the 12 firms studied were sometimes given direct orders from upper management to turn in greater profits than were budgeted. In some of these firms, the orders were given virtually every quarter.

## Reading 10-5: A Closer Look at Rolling Budgets

by Marc P. Lynn and Roland L. Madison

**THE CHALLENGES ASSOCIATED WITH AN EFFECTIVE IMPLEMENTATION OF ROLLING BUDGETS ARE MANAGEMENT CHALLENGES, AND SOFTWARE TECHNOLOGY CAN ONLY BECOME PART OF THE SOLUTION WHEN MANAGERS ARE READY TO USE IT TO ENHANCE THEIR DECISION MAKING.**

Businesses are increasingly using *rolling budgets*. Also called *continuous budgeting*, rolling budgets always involve maintaining a plan for a specified time period in the future. To implement rolling budgets, many advocate leveraging new technological resources, which means software. It must be understood that the technology (e.g., bolt-on software packages) is not the solution. It is a tool by which and an environment in which management can have the opportunity to develop solution sets.

Published surveys of financial officers of the largest industrial companies in the United States, Australia, Holland, Japan, and the United Kingdom show a number of interesting similarities as well as differences in budgeting practices across countries.<sup>1</sup> First, the use of master budgets is very widespread in all of these countries. Another significant finding is that financial managers in many countries distinguish between cost behavior patterns—variable versus fixed costs—for a common reason: they want to prepare more meaningful budgets by building flexibility into the model.

How do these facts impact the concept of rolling budgets? Rolling budgets always involve maintaining a plan for a specified time period in the future. This result is achieved by adding a new time period in the future as the current time period that ended is dropped. Large companies, such as Electrolux and General Electric, prepare strategic plans and then integrate annual operating budgets that are divided into four-quarter rolling budgets, and smaller high-tech public companies, such as Keithley Instruments in Solon, Ohio, follow a similar pattern of planning.

The annual operating budgets are prepared based upon best estimates of what management expects to occur and wants to achieve during the coming year. Flexibility is built into the process by considering how costs and revenues will change if different levels of activity occur

(e.g., flexible budgeting), and each quarter's changes are made to reflect changes in the economic and financial environment—things such as what the competition is doing, how the economy is spending for capital goods, and any planned changes in their product mix (adding or dropping a product line). In short, sound managers operate an entity with one eye always on the horizon, and a well-prepared business plan as reflected in a “flexible rolling budget” can be one of the financial managers' best tools to assist them in their role of planning and controlling the operations of this company.

In his article “Budgets on a Roll,” Randy Myers identified a number of problems with annual static budgets.<sup>2</sup> A closer look, however, reveals that these problems were really management or human resource problems, where the proper development and use of budgets as just described was simply not understood. One example cited was that of an “account director” who would land several large clients “early in the year and make his annual budget” and then “coast” the rest of the year. This is not a problem with the budgeting process. It is a prime example of inept management and human resource functions that do not know how to plan and develop proper incentive systems.

### **COSTLY SOFTWARE CANNOT HELP POOR MANAGEMENT**

The implementation of costly software based upon fixed algorithms that merely permit one to roll the budget forward on a monthly basis without looking at the big picture is not a solution for poor planning or for a lackluster management team. If the management of any company allows its sales force to play such games in the planning process, shareholders likely would not value the financial expenditure for software that merely accelerates the game. Maybe heads should roll before the budget rolls.

Electronic spreadsheets such as Microsoft's Excel may be widely used for supporting the budgeting process, but if the data to populate the spreadsheets does not come from the corporate database directly, maintaining data integrity is a real problem. The use of other software packages that are more directly integrated into the corporate database certainly eases this problem, but it must be remembered and understood that budgeting is not a piece of software nor simply a mindless algorithm. It is a management process, and software is merely a tool to help facilitate this process.

It has been said that "Implementing rolling budgets doesn't necessarily require any fundamental change in the way a company has been doing its budgets—except, of course, it no longer does the job just once a year."<sup>3</sup> But maybe one should take a closer look at Eden before hunting for apples. Assume that a company that has been constrained by limitations imposed by static budgets suddenly finds itself able to roll them monthly with ease. Does the company now reevaluate salaries and bonuses on a monthly basis? If so, how is this done? If not, then what expectations might the company have to alleviate problems posed by employees who get lucky and meet their quotas early? Who will make such decisions, and how will they get implemented? Are the company's managers really ready to identify, let alone deal with, all the associated issues at the clerical and tactical levels? While a new budgeting system might be ready to roll, how prepared is the company's human resource (HR) system?

This is where integrated information systems, especially well-implemented enterprise software, can be very helpful. One may not be ready to answer all of the key questions or even know all of the questions that need to be asked, but at least management would have a good chance of finding out whether and how its technology can respond to the challenge. But the technology (e.g., bolt-on software packages) is not the solution. To use an analogy, if your grandfather is having trouble driving, putting him behind the wheel of a faster, more powerful automobile isn't the correct solution to the problem. Although you may have really great maintenance and support for the powerful new car, your grandfather isn't the only one who has to drive it, even though he may be the one who determines where to go, when, how, and

why. Now, if your grandfather is actually the CEO of the company, and the "new car" is really a rolling budget, everyone in management had better look out because you don't know whom the grandfather will crash into with the new high-powered toy!

Reports generated from the company's main information systems will not coincide with data in the spreadsheet unless the spreadsheet uses the main systems as its data source. Unless one coordinates and manages this effectively, the data transfer might be in a precarious position. It is a major challenge, but such problems are usually solvable. What is *not* always solvable easily is reflecting things done outside the main corporate database system (for example, in spreadsheets) and bringing them back into the main system's environment. This process is not something that must always be avoided, and many functions supporting decision making are, in fact, best handled by such approaches. If management uses these "external" tools to determine policies, new bonus levels, or other incentive actions, the flexibility obtained in the new spreadsheet or financial modeling software is not necessarily transferable to the main system's database or processing environment.

Even if a firm can get what is needed from the external package, can it efficiently share, capture, or update data in the main system without modification? Remember that re-keying large amounts of data and relying on coworkers to guarantee the integrity of many complex spreadsheets are issues that need to be addressed. It may be very challenging to determine what modifications are necessary, how much they will cost, and what impact such modifications may have on other system functions, such as user screens, reports, calculations, database queries, links with other integrated products, other "boltons" being used, support agreements, warranties, and version and/or revision upgrades. When a company is using a very complex beast such as SAP or Oracle enterprise systems, nothing is going to be easy, quick, or inexpensive. If the built-in capabilities of these products can be used without modification, this solution is likely the best option to avoid the problems just identified.

One problem in trying to get users to accept the built-in capabilities without making modifications is that the Excel spreadsheets they have been using are easier and



more familiar. Furthermore, users are not constrained by having to use real data from the actual corporate database. Finally, without modifications to these systems, a fair amount of training is usually required. In addition, they have probably been using spreadsheets to perform these various functions for quite a while, so why should they change now? This is when change management rears its ugly head once again, but isn't that what this is all about?

### **MANAGEMENT, NOT SOFTWARE, IS KEY TO SUCCESS**

As previously noted, training is a major issue that must be addressed when contemplating any new software, but in this case the firm is not merely dealing with the software but also with new business processes and decision points. Training is costly, requires substantial planning, and can only be considered once the business process issues have been addressed. Breaking through the constraints of static budgets may provide great benefits, but not if too many necks are broken in the process. Just imagine this flying-related analogy. You are accustomed to flying a Piper Cub, which is a simple plane with *fixed landing gear* that does not retract. Suddenly you get the urge to buy a Learjet. Just because you are familiar and comfortable with the Cub, would you pull out the Cub's landing checklist, which *does not* include a "gear down" instruction, as you approach the airport in your Learjet? You might be enjoying the increased speed and power of the new jet, but eventually you will crash. And don't blame the Learjet or the Cub. The pilot did it all by himself!

What we mean by this analogy is: Can you do a better job of managing your company by finding ways to make the budgeting process better? Certainly you can! Can software be a key tool? The answer is a resounding "Yes!" But software is no panacea. Like anything else in business or in life, changing a key step in a complex system is not as easy as one would like to believe. Transitioning to rolling budgets and ignoring the potential of flexible budgets based on different activity levels and cost behavior is not easy. A rolling budget is not "annual budgeting done more frequently."

There is no doubt that management can do a better job of running the company by finding ways to make the

budgeting process better, and new software can be a key tool in this improvement process. But like anything else in the business world, it is not going to be as easy to implement as the providers of these new software packages would like companies to believe. Transitioning to rolling budgets is not easy, and, once again, it is not annual budgeting done more frequently. If one understands and accepts this fact and wants to investigate some software approaches that could be helpful, a good place to start might be CFO.com's Budgeting and Planning Software Providers list, available at <http://www.cfo.com/chart.cfm/3036961>. But please do not stop at this point. Remember, no challenge of this nature will be overcome by a piece of software alone. ■

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### **ENDNOTES**

<sup>1</sup> Eric W. Noreen and Ray H. Garrison, *Managerial Accounting*, 10<sup>th</sup> ed., McGraw-Hill Irwin: New York, NY (2003).

<sup>2</sup> Randy Myers, "Budgets on a Roll," *Journal of Accountancy*, December 2001, <http://www.aicpa.org/pubs/jofa/dec2001/myers.htm>.

<sup>3</sup> Ibid.

### **FURTHER READING**

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Marie Leone, "Major Miners," CFO.com, May 6, 2002. <http://www.cfo.com/article.cfm/3004532>.

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## Practical Example: Static Budget vs. Rolling Budgets

When one of the authors was on a business trip, he met a young account manager for a large consulting firm. The account manager was essentially a salesperson who sold expert consulting services. The manager was about 28 years old, held a college degree in marketing, had worked for the same firm for six years, and was evaluated based upon meeting the sales goals in a master static budget. The manager received a modest base salary but could earn a 5% bonus if he achieved \$1.5 million in consulting sales for the year.

The manager said he had never failed to meet the annual goal and had always met it by Labor Day. When asked what he did for the rest of the year, he said, "I coast and spend more time with my girlfriend." I asked if there were any incentive to make \$2 million in sales versus meeting the annual budget number. His reply was: "Not really—the bonus rate jumps to 6% on the extra half-million in sales, another \$30,000. I already make over a hundred grand and my girlfriend earns about \$85,000—so why kill myself?"

After five years of experience, it should be obvious to top management that the annual goal the manager was given at the start of the year was well within his ability to achieve—and long before the end of the year—and the additional 1% bump in commission was not an adequate incentive to motivate the manager to generate the additional revenue.

If compensation is the primary motivator for sales managers, then there are a variety of incentive alternatives available without spending substantial money on purchasing an ERP system and buying expensive software to convert to a rolling budget model. A simple change in the incremental bonus rate may be the solution. For example, a series of constantly rising bonus rates over a more narrow range of sales may be used. There is nothing wrong with the static budget, but top management does not have to tell the account manager what his annual sales goal is at the beginning of the year. Even if top management *does* know what they want from their personnel and the personnel are capable of making even greater sales, give them the incentive to perform.

Thus, a quarterly rolling budget with a goal of \$400,000 in sales for the first quarter is introduced, and a 4% bonus is granted for reaching that goal. Near the start of the second quarter, a budget for \$500,000 is developed with a 5% bonus. Next, based upon the results of the first two quarters and a view of the horizon of the next six months, budgets of \$600,000 with an 8% bonus for the third quarter and \$700,000 with a 10% bonus for the fourth quarter are introduced.

This rolling budget illustration removes the incentive for the account manager to hit a couple of large clients early in the year and coast for the rest of the year. If top management is satisfied with \$1.5 million in sales but wants to reach \$2 million, it must give the manager the incentive to perform for the full year to reach his potential and the higher goal. While a rolling budget may be used to accomplish this goal, it is not necessary: A simple modification in the incentive plan may help reach the sales objective.

## Reading 10-5: Budgeting—Perspectives From The Real World

by Karen A. Shastri and David E. Stout

**A SURVEY OF SENIOR ACCOUNTING AND FINANCE MANAGERS EXAMINES THE BUDGETING PROCESS AT FOR-PROFIT COMPANIES, INCLUDING THE USEFULNESS AND PERCEIVED VALUE OF THE PROCESS, USERS' SATISFACTION WITH IT, AND THE IMPEDIMENTS AND CHALLENGES TO BUDGETING.**

The value of the budgeting process has been the subject of intense debate over the past few years. In their 2003 book, *Beyond Budgeting*, Jeremy Hope and Robin Fraser suggest that the traditional budgeting process is outdated and dysfunctional and, therefore, should be abandoned.<sup>1</sup> Alternatively, a 2007 survey by Theresa Libby and R. Murray Lindsay offers evidence that senior accounting and finance managers find the budgeting process to be more helpful than harmful overall and that there is a perception that operating managers could not function well without budgets.<sup>2</sup>

The Libby and Lindsay study provides answers to some important, but general, questions regarding the budgeting process, including whether accounting and finance managers' organizations planned to abandon budgeting and whether respondents agreed with some of the major criticisms of the budgeting process.

We conducted a follow-up survey to the Libby and Lindsay study with the goal of providing answers to some more-detailed questions:

- How are budgets in modern (for-profit) organizations prepared? That is, what are the descriptive characteristics of the budgeting process as used today?
- Does budgeting add value for organizations? If so, how?
- How satisfied are finance and accounting managers regarding the role that budgets play within an organization?
- What are the primary behavioral consequences, both positive and negative, of using budgets?

- What is the relationship, if any, between budgets and other management processes—i.e., are they integrated in any meaningful sense?

### THE SURVEY

In November 2007, questionnaires were sent via e-mail to 29,501 members of the Institute of Management Accountants (IMA®) who, based on job title, were likely involved in the budgeting process. These members included general management, corporate management, public accounting, general accounting, cost accounting, and environmental accounting staff members. Participants were asked to respond to questions based on their position in the organization (i.e., “company-level” or “segment-level,” where “segment” was defined variously as a subsidiary, division, department, or product line).

A total of 815 members completed the survey. Because the focus of our study was *for-profit* entities, as with the Libby and Lindsay study, we excluded responses from managers at nonprofit or governmental entities. This resulted in a final sample of 720 respondents who worked at publicly traded corporations (52.5%), privately held corporations (42.4%), and partnerships (5.1%), mostly in the United States.

Approximately 48% of respondents work at the corporate level, with the remainder at the segment level. The highest percentage of respondents was in manufacturing (28.1%), followed by healthcare (9.9%). In regards to company size, the largest percentage of respondents (35.7%) reported company revenues between \$1 billion and \$50 billion and segment revenues between \$50 million and \$500 million (34%). The largest group responding to our

survey was controllers (25.5%). On average, our respondents had 13 years of budgeting experience.

### *Descriptive Characteristics of the Budgeting Process*

The initial part of the instrument asked for descriptive information regarding the budgeting process at the respondent's organization. Specifically, we wanted to know how budgets were developed and how they were used for planning and control purposes.

According to 69.2% of respondents, the development of the budget is accomplished via a *negotiated process* (a combination of "top down" and "bottom up"). Further, 85% of respondents stated that this process was the same throughout the entire company, with exceptions due to merger/acquisition activity or international operations. These results are roughly consistent across the two groups of respondents, corporate and segment.

In terms of planning, 69.5% of respondents indicated that the primary planning tool continues to be the *static budget*, defined as a budget valid for only one planned volume level of activity for the upcoming budget period. By definition, the static budget provides scant opportunity to adapt quickly, so it is interesting to learn that the majority of respondents continue to use the static budget given the available options for planning purposes, such as continuous or rolling budgets, flexible budgets, and zero-based budgets (ZBB).

Regarding feedback/control purposes, most respondents compare actual results to budgeted results on a *monthly* basis using both financial (primarily revenues and expenses) and nonfinancial measures (primarily customer satisfaction and market share). Moreover, 78% of respondents reported that managerial compensation plans, including incentive compensation formulas, incorporate

achievement of specified budget objectives for *financial* performance measures, while 62.7% reported the same for *nonfinancial* measures.

All of these results are generally consistent between corporate- and segment-level respondents.

### **The Usefulness and Value of Budgeting Systems**

The next part of the survey asked respondents for their opinions regarding the *usefulness* of budgeting systems in relation to specific business objectives: strategic planning, resource/operational planning, operational control, communication, coordination/teamwork across subunits, coordination/teamwork across functional areas, motivation, and incentive rewards determination. This list of objectives parallels what we traditionally teach in managerial and cost accounting courses.

As noted in Table 1, Panel A, the majority of respondents believes that the budget is either "useful" or "very useful" as it relates to the list of business objectives. In a traditional management accounting setting, the budget was considered to be important for planning and control purposes only. The fact that these preparers indicated that it is also useful for other functions such as strategic planning, communication, and incentive rewards suggests that there may be a forward-looking movement from relying solely on the annual numbers as a planning and control mechanism to a perception that the budget can be part of the strategic management process of an organization.

While many respondents indicated the budget is useful for all of the listed objectives, there were some for which more than 10% of respondents indicated that the budget process is either "not very useful" or "not at all useful": coordination across subunits (21.4%) and functional areas (19.1%), motivation (14.1%), and incentive rewards determination (11.8%). As such, these areas represent fruitful topics for additional

research or critical examination into the reasoning behind these perceptions.

The perceived usefulness of the budgeting process does not vary much based on whether respondents are at the corporate or segment level. One difference, as seen in Table 1, Panel B, is that segment-level respondents perceive the budget to be more useful as it relates to strategic planning, yet corporate-level respondents indicate greater usefulness in terms of resource/operational planning. Corporate-level respondents also perceive the budget to be more useful for coordinating across subunits as well as a tool for incentive rewards determination.

Respondents also were asked to denote their *level of satisfaction* with their organization's budgeting system as it relates to the list of management objectives. Satisfaction ratings for the full respondent sample are presented in Table 2, Panel A. More than 40% of the respondents are largely satisfied with the budgeting process except in relation to coordination/ teamwork across business units. Operational control was cited as the one objective (or benefit) of budgeting where individuals are most satisfied. This finding is not surprising given that operational control is one of the classic purposes for preparing and using budgets.

One other observation from Table 2, Panel A, is that more than 10% of respondents are *not* satisfied with the budgeting process. This disparity between the usefulness of budgeting in general compared to increased dissatisfaction within a specific organizational context suggests that some of the respondents feel that the budgeting process within their respective organization is not optimal and possibly does not produce the kind of results they feel are possible.

Table 2, Panel B, shows that segment-level respondents are relatively more satisfied with the budgeting process than are corporate-level respondents, with one exception: Corporate respondents are more satisfied with the budget as it relates to resource and operational planning. The difference for this attribute,

however, does not appear to be substantial.

It is no secret that the accounting/finance function today is being challenged to provide greater value-added services to the organization. Consequently, we asked accounting/finance managers about the value that was added to the organization as a result of their respective budgeting process: "Increasingly, the accounting/ finance function is being challenged to provide value-added services to management. How would you rate your budgetary process in terms of adding value to your organization?" Forty percent of respondents feel that the budgeting process meets this overall goal.<sup>3</sup>

At the same time, approximately 23% of respondents believe that the budgeting process adds *relatively little value* to the organization. This result is being driven more by the segment accountants—29% of them held this view. The difference between these results and the usefulness and satisfaction ratings reported in Tables 1 and 2 are somewhat puzzling. One possible explanation is that respondents were applying a cost-benefit test when judging "value added." Another possibility—and possible limitation of the study—is that the term "value added" may mean different things to different respondents.

A clue to resolving the inconsistency in results is provided by the open-ended responses to the question: "What impediments/challenges exist that affect the ability of an organization's budgetary process to add value to the firm?" Responses lend support to concerns being raised by critics of budgeting and simultaneously suggest strategies for improving the budgeting process. While some of our survey respondents indicated there were no problems associated with the budgeting process at their organization, a number of common concerns were identified. They are summarized in Table 3. In particular, challenges and impediments focus on unrealistic goals, management accountability, lack of or constrained resources, and the political climate surrounding the firm.

## Behavioral Consequences of Budgeting

We also sought practitioner perceptions regarding the behavioral consequences (both positive and negative) associated with the use of budgets. A listing of putative negative behavioral effects (e.g., “budgets pressure employees to achieve results”) and summary response data from the sample is provided in Figure 1.

Respondents largely believe that budgets *do not*:

- Block employee initiatives,
- Unduly pressure managers to make decisions with a short-term focus,
- Inhibit management responses to change,
- Unnecessarily pressure employees to achieve targets, or
- Inappropriately reward those skilled in the negotiating process. One attribute where the responses might be of concern is the perception that the budgeting process encourages a *myopic planning horizon*. Clearly, this sentiment suggests that some organizations need to pay greater attention to linking budgeting to strategy.

In terms of the breakdown between corporate- vs. segment-level respondents, segment-level respondents indicated a stronger sentiment with the issues presented in Figure 1. Compared to corporate-level respondents, more segment-level managers either agreed or strongly agreed that the budget:

- Blocks employee initiatives,
- Pressures managers to make decisions with a short-term focus,
- Inhibits management response to change,
- Pressures employees to achieve targets,
- Inappropriately rewards those skilled in the negotiating process, and
- Encourages a myopic planning horizon.

In fact, almost twice as many segment-level employees than corporate-level employees felt

that budgets had negative behavioral consequences in terms of employee initiatives, motivating short-term decision-making, and pressure to achieve targets.

Figure 2 presents perceived *positive* behavioral effects of budgeting. There was general agreement among respondents that budgets can be used to support continuous improvement, to provide managers with information they need to respond to change, to motivate information and knowledge sharing across subunits, and to encourage appropriate risk taking.

For either the “agree” or “strongly agree” responses, a lower percentage of segment managers (details not reported here) indicated that budgets can be used to support continuous improvement and motivate information and knowledge sharing across subunits. These subgroup results, combined with the subgroup results associated with Figure 1, suggest that there is more support for the budgeting process as a value-added proposition at the corporate level compared to the segment level.

## Relationship Between Budgeting and Other Management Practices

A budget that is a part of a firm’s strategic planning process would likely be integrated with other management practices. To explore these relationships, we asked respondents whether their company (or subunit, as appropriate) used any of the following: activity-based costing (ABC), target costing, supply-chain management, or the balanced scorecard (BSC). Respondents were also asked if those individual practices, if employed, were integrated into the budgeting process.

The most frequently used practices were supply-chain management and the balanced scorecard, both of which are linked to the budgeting process when used. Approximately one-third of respondents’ organizations use ABC as a management tool, with approximately 75% integrating it with budgeting. Slightly greater than one-third of respondents’ organizations reported the use of target costing—77% of which link

target costing to the budgeting process. In short, responses indicate some evidence that managers perceive the budgeting function as capable of being integrated with modern management practices.

### **Future Research**

Our study provides an up-to-date, real-world look at budgeting practices at a sample of U.S. profit-seeking organizations. It updates and extends the recent study by Libby and Lindsay. In particular, we provide descriptive information about current practices in budgeting as well as the perceptions of seasoned individuals as to the behavioral consequences of budgeting and the value of budgeting vis-à-vis a set of business objectives.

The research done here can be extended in several ways. Both our study and that of Libby and Lindsay obtained survey evidence from accounting/finance managers. An obvious extension to both studies would be to survey operational managers (i.e., “users”) to determine the extent to which their views are consistent with the views of finance/accounting personnel. Another direction for future research would be to examine the statistical relationship between budgeting practices and financial performance variables (e.g., stock price or stock returns). Such a study could provide evidence as to the market’s perception of different budgeting practices.

In addition, while the present study focused on profit-seeking companies, a future research project could focus on the perceptions of managers (both preparers and users) from the not-for-profit sector, including those from healthcare. Further, some level of dissatisfaction regarding the value added from the budgeting process was noted by respondents to our survey. Thus, future research is needed to determine reasons for this dissatisfaction, the context in which such dissatisfaction occurs, and recommendations for change/ improvement. Finally, there are some firms that have moved away from the budgeting process as it is commonly construed. A study to determine conditions under which

such a move is tenable would contribute greatly to our knowledge of the budgeting process.

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### **ENDNOTES**

<sup>1</sup> Jeremy Hope and Robin Fraser, *Beyond Budgeting: How Managers Can Break Free from the Annual Performance Trap*, HBS Press: Boston, MA (2003).

<sup>2</sup> Theresa Libby and R. Murray Lindsay, “Beyond Budgeting or Better Budgeting?” *Strategic Finance* (August 2007), pp. 46-51.

<sup>3</sup> We stress again the point that our respondents work in accounting/finance—i.e., are “preparers” of information. Therefore, there may be some positive response bias because of the nature of the sample.

**Table 1: Perceived Usefulness of the Budget**

**Panel A: Aggregate Results**

<b>Business Objectives</b>	<b>Very Useful/ Useful</b>	<b>Somewhat Useful</b>	<b>Not Very Useful/Not Useful</b>	<b>Don't Know/No Opinion</b>	<b>N</b>
Strategic Planning <sup>1</sup>	60.0%	24.4%	10.5%	5.1%	488
Resource/Operational Planning <sup>2</sup>	73.5%	18.7%	3.9%	3.9%	487
Operational Control <sup>3</sup>	84.3%	10.1%	4.1%	1.4%	485
Communication <sup>4</sup>	69.9%	19.0%	8.7%	2.5%	485
Coordination/Teamwork:					
across Subunits <sup>5</sup>	51.4%	21.6%	21.4%	5.6%	486
across Functional Areas <sup>6</sup>	53.3%	23.5%	19.1%	4.1%	486
Motivation <sup>7</sup>	58.8%	24.0%	14.1%	3.1%	483
Incentive Rewards Determination <sup>8</sup>	68.1%	14.9%	11.8%	5.2%	483

**Panel B: Corporate and Segment Subgroups**

<b>Business Objectives</b>	<b>Very Useful/Useful</b>	
	<b>Corporate Responses</b>	<b>Segment Responses</b>
Strategic Planning	50.7%	54.5%
Resource/Operational Planning	76.1%	73.0%
Operational Control	86.1%	85.5%
Communication	69.1%	70.5%
Coordination/Teamwork across Subunits	52.8%	49.4%
Coordination/Teamwork across Functional Areas	53.3%	54.5%
Motivation	56.6%	56.9%
Incentive Rewards Determination	70.1%	67.9%

**NOTES:**

<sup>1</sup> To support strategic initiatives specified by top management.

<sup>2</sup> To estimate resources required for forecasted operations or to anticipate financing needs.

<sup>3</sup> To ensure that actual results are consistent with planned results; to provide feedback/assessment regarding operating activities.

<sup>4</sup> To provide a road map for employees to deliver output/services as expected by management; to communicate how individual units of the organization contribute to the overall strategy.

<sup>5</sup> To encourage teamwork across business *segments* (divisions, product lines, etc.).

<sup>6</sup> To encourage teamwork across business *functions* (finance, marketing, systems, etc.).

<sup>7</sup> To encourage employees to put forth effort in terms of stated goals and objectives of the organization.

<sup>8</sup> To determine bonuses or other benefits based on comparison of actual vs. budget.



**Table 2: Respondent Satisfaction with the Budgeting Process**

**Panel A: Aggregate Results**

<b>Business Objectives</b>	<b>Satisfied/ Very Satisfied</b>	<b>Neutral</b>	<b>Dissatisfied/ Very Dissatisfied</b>	<b>Not Applicable</b>	<b>N</b>
Strategic Planning	49.2%	27.7%	21.6%	1.5%	459
Resource/Operational Planning	55.8%	24.1%	17.9%	2.2%	457
Operational Control	64.9%	18.3%	15.9%	0.9%	459
Communication	49.5%	27.1%	21.9%	1.5%	457
Coordination/Teamwork Across <i>Subunits</i>	35.5%	33.6%	27.2%	3.7%	459
Coordination/Teamwork Across <i>Functional Areas</i>	41.8%	31.9%	24.6%	1.8%	455
Motivation	43.0%	32.1%	24.0%	0.9%	458
Determination of Incentive Rewards	45.7%	26.3%	22.8%	5.3%	457

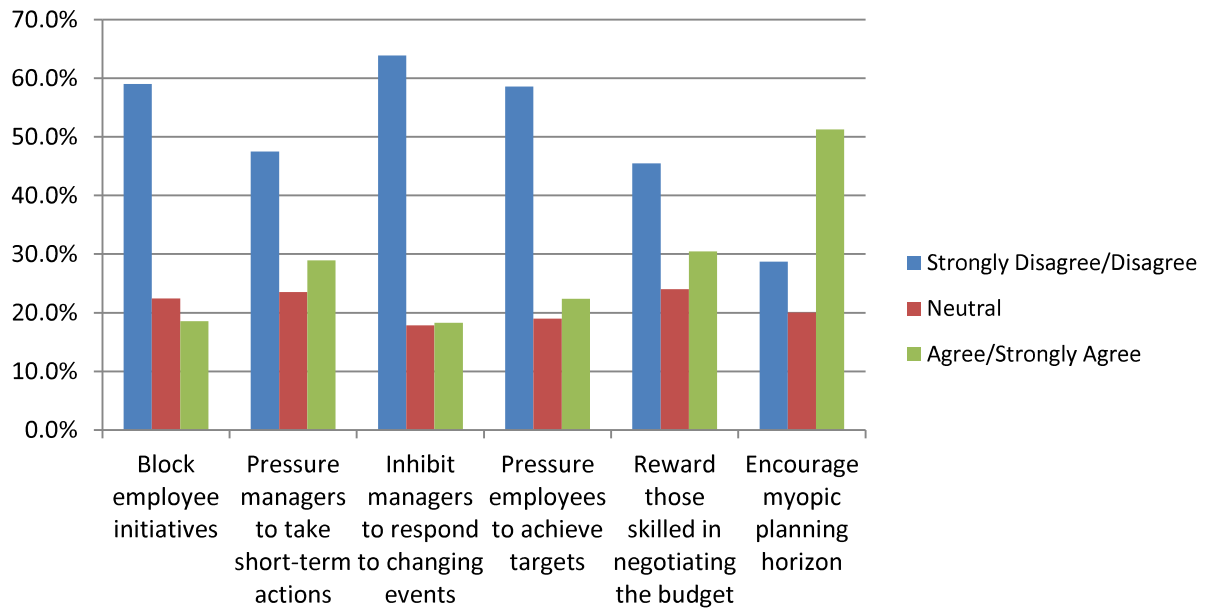
**Panel B: Corporate and Segment Responses**

<b>Business Objectives</b>	<b>Satisfied/Very Satisfied</b>	
	<b>Corporate Responses</b>	<b>Segment Responses</b>
Strategic Planning	43.1%	44.2%
Resource/Operational Planning	53.5%	52.5%
Operational Control	59.2%	62.8%
Communication	41.1%	45.8%
Coordination/Teamwork Across Subunits	28.5%	32.2%
Coordination/Teamwork Across Functional Areas	37.8%	40.2%
Motivation	33.8%	38.0%
Determination of Incentive Rewards	41.1%	44.0%

**Table 3: Impediments/Challenges Associated with the Budgeting Process**

<ul style="list-style-type: none"><li>• Unrealistic goals set for the budget<ul style="list-style-type: none"><li>○ Problems linking the budget with the strategic plan</li></ul></li><li>• Lack of accountability by some managers:<ul style="list-style-type: none"><li>○ Lack of buy-in by non-accounting managers</li><li>○ Amount of “fluff” built into the budgets ostensibly because of the reward system</li><li>○ Tendency of some managers to shirk their responsibilities in terms of budget preparation</li></ul></li><li>• Changes in product mix during the budget period</li><li>• Changing costs during the budget period</li><li>• Accuracy of budget estimates<ul style="list-style-type: none"><li>○ Revenue planning is inadequate</li></ul></li><li>• Lack of resources in terms of time, staff, and a system to create the budget<ul style="list-style-type: none"><li>○ Initial budget time is too time consuming</li><li>○ Rework cycle time is too time consuming</li></ul></li><li>• Inability to correctly prioritize for planning</li><li>• The politics and culture of the firm<ul style="list-style-type: none"><li>○ Silo attitude adopted throughout the firm</li><li>○ Lack of communication and information-sharing across firm</li><li>○ Diverse management and geography</li><li>○ Reorganizations that create budgeting conflicts</li></ul></li><li>• Constraints due economic changes, market conditions, or the regulatory environment</li></ul>
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**Figure 1**  
**Negative Behavioral Consequences of Budgeting**



**Figure 2**  
**Positive Behavioral Consequences of Budgeting**

