Chapter 6

Strategic Planning and Budgeting

**DEFINITION AND ROLE OF BUDGETS**

A budget is simply a plan. Despite any unpleasant connotations the term may have picked up over time, a budget is simply a plan. In business budgets are formalized (i.e. written down) and quantitative (expressed in dollars and/or units).

For an organization to excel, its management needs vision. Great managers are those individuals under whose stewardship organizations make great strides forward. In some cases, vision may come from inspiration that only a few people ever have. In many cases, however, vision is a result of hard work and careful planning. What is the organization trying to achieve? Why does it want to achieve that goal? How does it intend to translate that goal into results? Successful managers and organizations specifically address these questions, rather than simply letting things happen. This is accomplished through a process of strategic planning and the development of budgets.

**STRATEGIC PLAN**

A strategic plan is a document that sets the direction the organization will take to achieve its underlying mission. The mission of the organization represents its primary reason for being in business. It explains in broad terms the purpose and goals of the organization. The strategic plan selects the primary approaches that the organization will take to achieve those goals. Generally, strategic plans do not have specific financial targets. However, they set the stage for specific, detailed budgets that will be established to achieve the goals.

For example, suppose that the mission of a soup kitchen was to ensure an adequate supply of nutritious food for the homeless. It could attempt to achieve that mission by any of a number of different approaches. It could be a lobbying organization, raising money and using it to lobby for legislation requiring the government to provide nutritious food for the homeless. That would be one strategy. Another strategy would be to solicit donations of food and money, and to use those resources to prepare and serve meals directly to the homeless. Suppose that the soup kitchen chose the latter strategy.

In addition to a strategy, the strategic plan should have goals. For example, given its strategy to directly provide meals, the soup kitchen might adopt the following two goals (among others):

* Increase the percentage of the target population served from 20 percent to 60 percent within five years.
* Expand funding sources to cover the cost of the increase in services.

Once you have a strategic plan that identifies your strategies and goals, the next step is to translate the goals of the strategic plan into attainable objectives.

**LONG-RANGE PLAN**

While the strategic plan establishes goals and broad strategies, the long-range plan considers how to achieve those goals. Long-range plans establish the major activities that will have to be carried out in the coming three to five years. This process provides a link between the strategic plan and the day-to-day activities of the organization.

For example, one element of the strategic plan for the soup kitchen is expansion of meals provided from 20 percent to 60 percent of the target population. This cannot be achieved by simply carrying out the existing daily routine, day after day, year after year. The managers will have to determine what must happen to attain the goals. A variety of approaches or tactics might be considered and developed into a long-range plan.

The managers decide that the most efficient way to expand from 20 percent to 60 percent coverage (the goal) would be to add three new locations and four more vehicles (specific tactics to achieve the goal). Money will be needed to buy equipment and vehicles, and to pay rent, buy food, and hire staff. The long-range plan will also have to consider how to raise the money and when to spend it (more tactics). A reasonable long-range plan for the soup kitchen might include the following objectives:

* Year 1: Establish fund-raising campaign, and begin fund-raising. Raise enough money to open one new site.
* Year 2: Add a food distribution/soup kitchen location. Raise additional money to acquire and operate a vehicle and open another location. Solicit more restaurants for leftover food donations.
* Year 3: Add another food distribution/soup kitchen location and a new vehicle. Raise additional money to acquire and operate a vehicle and open another location. Solicit more restaurants for leftover food donations.
* Year 4: Add another food distribution/soup kitchen location and a new vehicle. Raise additional money to acquire and operate two vehicles. Solicit more restaurants for leftover food donations.
* Year 5: Add two new vehicles. Raise additional money to begin replacement of old kitchen equipment and old vehicles. Get enough contributions to at least reach a steady state where replacements take place as needed.

As can be seen from the above objectives, unless planning is done in year one to raise money, the organization will never be able to undertake the acquisition and expansion in years two through five. The organization cannot be satisfied with raising enough to get through the coming year. For it to thrive, rather than merely survive, it must think ahead. The long-range plan provides the opportunity to think ahead prior to making budgets for the coming year.

The objectives included in the long-range plan can be thought of as quantified targets. These targets can relate to both inputs and outputs. For example, we can think in terms of specific fund-raising objectives, specifying the total dollar amount of donations we plan to receive each year over the coming five years. We can also think in terms of the specific number of delivery vans to be purchased. These targets or objectives make it possible to create specific detailed budgets for the organization in financial terms.

**ANNUAL BUDGETS**

Each year the organization will prepare an operating budget, cash budget, and capital budget. These annual budgets are prepared to take the long range vision of the strategic and long-range plans and fill in the specific details of what has to happen over the coming year to keep the organization on track to accomplish its long term goals. Annual budgets provide specific itemization of resources to be used and resources to be generated over the coming year.

Budgets provide a number of benefits to organizations. They force managers to think ahead. When plans are made well in advance more choices are generally available than when decisions are made on a fire-fighting or crisis basis. Advance planning provides the necessary lead-time for effective decisions. Once decisions are made, they must be acted upon by the organization. Budgets provide the information needed for those decisions to be properly implemented. They also provide a tool to allow for effective evaluation of both departments and managers.

Another key use for a budget is as a tool of communication and coordination. Even if the Chief Executive Officer has great plans for the organization, they can only be put into operation if they are communicated to the appropriate individuals. The budget serves this purpose.

The operating budget provides all of the information necessary to prepare a budgeted income statement. It includes revenue projections, cost-of-goods-sold projections, including the projected costs of materials, labor, and overhead for a manufacturing firm, or cost of purchases for a merchandising firm; selling expenses; administrative expenses; and finally financing (interest cost) expenses. These separate elements are combined into a projected income statement. [Exhibit 6-1](https://jigsaw.chegg.com/books/9780808046912/epub/EPUB/xhtml/08_Chap06.xhtml#e6-1) provides an example of an operating budget.

Excel Exercise

Template 6 may be used to prepare an operating budget for your organization. The template is included at [https://www.CCHGroup.com/FANM2017](https://www.cchgroup.com/FANM2017) along with all other supplemental material.

**EXHIBIT 6-1
Executive Corporation
Operating Budget
Projected Revenues and Expenditures**

|  |
| --- |
| Revenues |
| Product Sales | $14,000,000 |
| Other | 500,000 |
| Total Revenues | $14,500,000 |
| Expenses |
| Cost of Goods Sold |
| Labor | $ 5,000,000 |
| Materials | 4,800,000 |
| Overhead | 1,700,000 |
| Selling Expenses | 1,500,000 |
| Administration | 500,000 |
| Interest | 600,000 |
| Total Expenses | $14,100,000 |
|   |   |
| Profit | $    400,000 |
|   |

The cash budget projects the cash inflows and cash outflows of the organization over the coming year. This budget is often broken down into monthly, or even more frequent, time periods so that the organization can assure that it will have sufficient cash balances at all time throughout the year. For example, even if cash collections from customers exceed routine day in and day out operating expenses, if we are constructing a new building, the cash outlays to pay for that construction must be taken into account in the cash budget to assure that we always have sufficient funds. Cash budgets are discussed in more detail later in this chapter.

In addition to the annual operating and cash budgets, there will be a capital budget for acquisition of capital assets. A capital acquisition is anything the organization buys that it expects will last for more than one year. Capital acquisitions often require special methods of analysis to evaluate whether they make financial sense for the organization. Capital budgeting and evaluation of proposed capital acquisitions is discussed in [Chapter 11](https://jigsaw.chegg.com/books/9780808046912/epub/EPUB/xhtml/08_Chap11.xhtml).

### BUDGET PREPARATION

#### Preliminaries

The first step in budget preparation is the completion of an environmental statement. The firm cannot effectively plan for the coming year without a clearly stated idea of what its position is vis-a-vis its suppliers, competitors, and customers. An annual evaluation of industry trends, changes in customer base, are likely to be unusually busytechnological changes, and so on can help the firm to better determine where it should be going.

The next step is for top management to develop a set of general objectives and policies. This statement should be a broad-based look at what the firm hopes to achieve. Is the coming year one of holding the line against competitors, or is it to be a year of rapid growth? Is the firm looking for domestic expansion, or establishment of foreign markets? Does the firm expect to increase the market share in existing products, or to be aggressive in the introduction of new products? If top management communicates the desired direction of the firm, middle management can set out to move in that direction.

Before the actual budget can be developed, a set of assumptions must be adopted. What will inflation be in the coming year? What actions do we expect competition to take that might affect our sales or the price of our product? Will suppliers be raising their prices? Will new sources of raw materials become available? Are there going to be more significant shifts in consumer demand? All of these and many more questions must be answered; but there is no way to know the answer, so assumptions must be made and communicated to those directly involved in the budget preparation process.

Finally, specific, measurable goals should be established. Here we are not dealing simply with the general direction of the firm, but with the actual operating objectives. For example, sales should increase by 10 percent and profits by 15 percent. These are two ambitious objectives—more often than not, a firm that doesn’t budget, or that doesn’t control the budget, will not have much success in achieving such goals.

#### Forecasting

A critical step in the budget process is the preparation of forecasts of what would happen under a variety of alternatives. What if we raise our price? What if we import partially assembled parts? What if we automate? In all of these cases, how much will we sell, at what price, and at what cost?

Forecasts can be quite simple, such as a projection that indicates that what happened this year will happen again next year. Or they can be based on extremely complex mathematical formulas. Most forecasting is based, to a major extent, on historical patterns. An accurate forecast must also consider any changes that may make the future different from the past. These changes can be due to various decisions we’ve made, improved technology, initiatives by competitors, changes in laws, world events, etc.

Computers make sophisticated forecasting techniques accessible to managers. Some software programs allow the user to select from a range of statistical forecasting methods, or to simply have the computer automatically select the best forecasting method for your data.

Some software programs can take seasonal patterns into account. If a firm has times of the year that are generally very busy or unusually slow for production, sales, or both, a forecast for the year as a whole is not fully satisfactory. A manager gains a significant advantage by knowing which months are likely to be unusually busy or slow, and how busy or slow. Such information may be used to minimize the cost of staffing and inventory throughout the year, while still allowing for adequate staff and inventory during peak periods of demand.

##### *Data Needs for Forecasting*

The forecasting process should begin with some basic assumptions about the likely future of the industry. Too often managers are myopic, looking within their own firms and missing industrywide cycles or trends. If the future sales outlook for the industry is turning negative, managers cannot ignore that information just because their own sales have historically been strong.

Working from a base of the outlook for the industry, managers can then turn their attention to a forecast of the company’s sales. Sales in the future are often largely a reflection of sales in the past. Information on how many units of each product or service have been sold in the last five to ten years provides a basis for the forecast of the future. Techniques to use this historical data for the forecast are discussed below. Once the historical data for sales is used to predict future sales, that information can be used to forecast the necessary materials, labor, and other expenses.

##### *What to Do When Historical Data Are Not Available*

At times historical data may not be available. This is generally the case when a new service or program is suggested. How can forecasts be made in the absence of such data? To some extent, one can rely on engineering calculations. A determination can be made of exactly what resources should be required for each unit of the service provided. Another useful approach  is to base such forecasts on the collective opinion of groups of individuals. Industrial experience has shown that when a team of experts arrives at a consensus, subjective forecasts can be reasonably accurate. There are two techniques for achieving consensus: Nominal Group and Delphi. Both approaches select a team of individuals who are likely to have reasoned insights with respect to the item being forecast.

The Nominal Group technique brings individuals together in a structured meeting. Each member writes down a forecast. The forecasts are then presented to the entire group without discussion. Once all of the forecasts have been revealed, the reasoning behind each one is discussed. Through a repetitive process, a group decision is eventually made.

There are weaknesses to this approach. In some cases it may be impossible to get the group to reach consensus. A more common problem concerns politics and personalities. As members of the group defend their forecasts, extraneous issues having to do with whose idea it is may bias the group decision. Some individuals may be reluctant to share their ideas in public for a variety of reasons.

The Delphi technique overcomes those weaknesses. In the Delphi approach, the group never meets. All forecasts are presented in writing to a group leader who provides summaries to all group members. After several rounds, a decision is made based on the collective responses. The weakness of the Delphi method is that it takes more time and is more cumbersome than the Nominal Group method. But, by avoiding a face-to-face meeting, the Delphi technique avoids confrontation. Decisions are based more on logic than on politics or personality.

##### *Forecasts Based on Historical Data*

In cases for which historical data do exist, forecasting is somewhat easier. Knowledge about the past is often an excellent starting point for predicting the future.

The simplest approach to forecasting using a series of historical data points is simply to take an average. The data for five years can be aggregated and divided by five to get an estimate for the coming year. Such an averaging approach, however, assumes that there is no underlying pattern and that results are essentially random.

A somewhat superior approach is the linear regression statistical technique. This method plots historical points and uses the information to develop a trend line. That trend is projected into the future to make a forecast. This is generally more accurate than a simple average. The limitation of regression is that it is based on a straight line. Straight lines do a poor job of forecasting seasonal patterns.

However, a number of forecasting software programs, such as SmartForecasts,[1](https://jigsaw.chegg.com/books/9780808046912/epub/EPUB/xhtml/08_Chap06.xhtml#fn_1) can produce curved-line forecasts. Such forecasts can more closely match a seasonal historical pattern. This results in a much more accurate forecast. These programs may be used to forecast overall sales or expenses, sales of a given product, expenses of a given type, and virtually anything else for which the organization has historical data.

Consider [Table 6-1](https://jigsaw.chegg.com/books/9780808046912/epub/EPUB/xhtml/08_Chap06.xhtml#t6-1). This table, for simplicity, provides quarterly data. Managers can further improve the usefulness of their forecasts by using monthly data. [Figure 6-1](https://jigsaw.chegg.com/books/9780808046912/epub/EPUB/xhtml/08_Chap06.xhtml#f6-1) provides a time-series forecast graph from the SmartForecasts program. Time is shown on the horizontal axis, beginning with the first quarter of 2015 and ending with the last quarter of 2018. Generally you would try to use five to ten years of historical data. In this simplified example, data from the first three years are used to forecast the fourth year. Sales in units are shown on the vertical axis.

TABLE 6-1
Historical Data

|  |  |
| --- | --- |
| QUARTER | SALES VOLUME |
| 2015 |
| January—March | 20,000 |
| April—June | 23,000 |
| July—September | 27,000 |
| October—December | 20,000 |
| 2016 |
| January—March | 21,000 |
| April—June | 25,000 |
| July—September | 29,000 |
| October—December | 20,000 |
| 2017 |
| January—March | 19,000 |
| April—June | 24,000 |
| July—September | 26,000 |
| October—December | 21,000 |

**FIGURE 6-1
Forecast for**[**Table 6-1**](https://jigsaw.chegg.com/books/9780808046912/epub/EPUB/xhtml/08_Chap06.xhtml#t6-1)**Data,
Using Curvilinear Forecasting**

The solid line from 2015:Q1 to 2017:Q4 in the graph in [Figure 6-1](https://jigsaw.chegg.com/books/9780808046912/epub/EPUB/xhtml/08_Chap06.xhtml#f6-1) represents the actual historical data points connected from quarter to quarter. The dashed line is the forecast line. For the future year being forecast, the prediction line is bracketed above and below by lines that represent a forecast interval. It is expected that 90 percent of the time, the actual results for the coming year will remain within that range. The forecast interval can be set at a different level if desired. For example, the range could be set at 99 percent, so that the actual result would fall outside of the predicted range in only one out of 100 predictions.

Table 6-2, generated by the computer program, provides the forecast for each of the next four quarters, along with lower and upper limits. This is extremely valuable managerial data. Not only do we have a forecast, but we also have detailed information that can be used for planning. For example, the third quarter will likely have a high rate of activity, but substantial reductions are likely in the fourth quarter. Based on the upper limit column in [Table 6-2](https://jigsaw.chegg.com/books/9780808046912/epub/EPUB/xhtml/08_Chap06.xhtml#t6-2), we know that we need to plan on only enough labor and materials to make 22,145 units in the fourth quarter, at most.

TABLE 6-2
Forecast and Forecast Interval Limits for [Figure 6-1](https://jigsaw.chegg.com/books/9780808046912/epub/EPUB/xhtml/08_Chap06.xhtml#f6-1)

|  |
| --- |
| APPROXIMATE 90 PERCENT FORECAST INTERVAL |
| TIME PERIOD | LOWER LIMIT | FORECAST | UPPER LIMIT |
| 2018-Q1 | 18,363 | 20,000 | 21,637 |
| 2018-Q2 | 22,363 | 24,000 | 25,637 |
| 2018-Q3 | 25,634 | 27,333 | 29,032 |
| 2018-Q4 | 18,522 | 20,333 | 22,145 |

Given that software programs such as this one are extremely easy to use, one cannot help but be impressed by the potential for improvements in a wide variety of forecasts throughout the organization. Nevertheless, managers should always bear in mind that forecasts are merely educated guesses about the future. As a manager you know more about your business than any formula or mathematical technique. Managers should rely on their judgment to modify forecasts to take into account factors the computer software may not have considered. Once forecasts have been made, the budgets can be prepared.

#### Departmental Budgets

Having completed the preliminary budget activities, and having prepared forecasts for the key elements of the budget, the next step is the actual preparation of the budget. The organizational budget consists of a compilation of the operating and capital budgets for the various departments. Based on the total requirements for each department, cash flow projections can also be made.

Each department must compile its budget based on the specific costs that it expects to encounter and, if it is a revenue center, the revenues that it projects as well. Budgets should be as detailed as possible, to ensure that all relevant items have been included. The budgeting task sometimes seems very complicated because of the specific forms that any given organization requires to be completed. However, the essential process is not complicated. Each organization strives to get an itemization of the various costs that it will encounter for the coming year, and the associated revenues.

Once these itemizations are completed, there is a process of evaluation. Are the requests reasonable? Do the departments need all of the resources they are requesting, or are they building fat into the budget? If the budget is carried out as specified, will it result in a satisfactory outcome for the organization? Will the sales be high enough? Will costs be low enough?

Even if a department’s budget is reasonable, there may still be limitations on what the organization can, or will, approve. It is possible that a series of capital expenditures, even if profitable in the long term, will require more cash than the organization believes will be available. Thus, there is an interplay between the operating and capital budgets prepared by departments, and the resulting projections of cash flows prepared by the financial office. All of the elements of the budget must come together to result in a satisfactory outcome for the organization before the individual components can be approved.

### FLEXIBLE BUDGETING

Preparing a budget requires many assumptions and predictions. One of the most prominent of these involves the workload level. Workload refers to the volume of goods or services that the organization will produce. If the volume of services, cost of services, and revenues related to services all rose and fell in equal proportions, this might not create a significant problem. However, that is generally not the case. Revenues may change in a sharply different proportion than costs. Managers need to be able to anticipate such variations. A flexible budget is a tool to aid managers in this area.

A flexible budget is an operating budget for varying workload levels. For example, suppose that Finkler Corporation expects to sell 40,000 units of its product. Its budget for the coming month appears in [Table 6-3](https://jigsaw.chegg.com/books/9780808046912/epub/EPUB/xhtml/08_Chap06.xhtml#t6-3). A surplus of $1,000 is projected. But what will happen if the number of units sold were to turn out to be 25% more or less than we had budgeted? Will profit rise to $1,250 or fall to $750?

TABLE 6-3
Operating Budget
for Next Month

|  |
| --- |
| Revenues |
| Sales of Goods | $165,000 |
| Total Revenue | $165,000 |
| Expenses |
| Salaries | $136,000 |
| Supplies | 10,000 |
| Rent | 12,000 |
| Other | 6,000 |
| Total Expense | $164,000 |
| Surplus | $    1,000 |
|   |

If the number of units of its product that are sold increases or decreases, revenue will change proportionately. However, some of the expenses are fixed costs; that is, they will not change as the volume of work changes. For example, if the volume of units sold goes up or down, rent will remain the same. For most organizations, however, at least some costs are variable; they vary as the volume of sales goes up or down. Finkler will have to buy more supplies if it gets busier.

A flexible budget takes the basic operating budget and adjusts it for the impact of possible workload changes. Assume revenue changes as units sold change, and supply expenses change as volume changes, but all other expenses are fixed. A flexible budget for Finkler, assuming a budget of 40,000 units sold, but considering the possibility of unit sales of 30,000 or 50,000 is shown in Figure 6-4. This flexible budget shows that if the number of units of service provided drop by 25% from 40,000 to 30,000, a loss of $37,750 is likely to occur. This information can serve as a warning to the managers. If they start seeing demand and the number of units sold decrease, they can anticipate the likely financial shortfall without waiting until the end of the month or later to find out. Actions can be taken to increase sales or find ways to cut costs. On the other hand, managers also see that if they can boost sales by 25%, there would be a substantial increase, well more than 25%, in the amount of profits earned.

TABLE 6-4
Finkler Corporation
Operating Budget
for Next Month

|  |  |
| --- | --- |
| Units Sold |   |
|   | 30,000 | 40,000 | 50,000 |
| Revenues |
| Sales of Goods | $123,750 | $165,000 | $206,250 |
| Total Revenue | $123,750 | $165,000 | $206,250 |
| Expenses |
| Salaries | $136,000 | $136,000 | $136,000 |
| Supplies | 7,500 |  10,000 |  12,500 |
| Rent | 12,000 |  12,000 |  12,000 |
| Other | 6,000 |    6,000 |    6,000 |
| Total Expense | $161,500 | $164,000 | $166,500 |
| Surplus | ($  37,750) | $    1,000 | $  39,750 |
|   |

The key to preparing a flexible budget is determining which numbers in the budget are likely to change and which are likely to remain the same. Will the costs that vary change in direct proportion to volume changes, or will their change be more or less than proportional? Management must work to understand revenue and cost structures enough to be able to anticipate the changes caused by volume variations.

Excel Exercise

See Template 7 for a worksheet that you may use to develop a flexible budget for your organization. The template is included at [https://www.CCHGroup.com/FANM2017](https://www.cchgroup.com/FANM2017) along with all other supplemental material.

### THE CASH BUDGET

The cash budget is a plan for expected cash receipts and payments. For organizations using an accrual basis of accounting (see [Chapter 4](https://jigsaw.chegg.com/books/9780808046912/epub/EPUB/xhtml/08_Chap04.xhtml)), the cash budget provides vital information. The operating budget focuses on revenues and expenses, regardless of when revenue is collected in cash or expenses are paid. However, organizations cannot afford to run out of cash, even if they are making profits! The cash budget provides the information needed to know if there will be adequate cash on hand at all times.

The cash budget allows the organization either to arrange for sources of cash to alleviate an expected shortage (such as a loan from the bank) or to change the organization’s planned revenues and expenses to avoid the shortage.

Monthly cash budgets are typically prepared for the coming year. Cash flow forecasting is complicated by the fact that collections and payments are not constant throughout the year. Monthly cash budgets assist in planning for short-term investments and loans during the year.

Cash budgets start with the cash balance expected to be on hand at the beginning of the month. The expected cash receipts for the month are added to this beginning balance to find the expected available cash for the month. Expected payments are subtracted to find the anticipated balance at the end of each month. Surpluses can be invested and are subtracted from the balance. Deficits require borrowing. The amount to be borrowed is added to the balance. The final projected balance for each month becomes the beginning balance for the next month. The general format for cash budgets is as follows:

|  |  |
| --- | --- |
|   | Beginning Cash |
|   | + Cash Receipts |
|   | Subtotal: Available Cash |
|   | − Less Cash Payments |
|   | Subtotal |
|   | + Borrowing or − Investments |
|   | Ending Cash Balance |

Excel Exercise

See Template 8 for a worksheet you may use to develop a detailed monthly cash budget for your organization. The template is included at [https://www.CCHGroup.com/FANM2017](https://www.cchgroup.com/FANM2017) along with all other supplemental material.

### ZERO-BASED BUDGETING

Zero-based budgeting (ZBB) is an approach that requires evaluation of all proposed spending. It gets its name from the fact that each department or program starts with a zero base of justified costs. All spending from zero on up must be explained and justified. ZBB helps to keep budgets from developing “fat.” No expenditure is automatically accepted without some explanation of why the organization is better off with that expenditure.

This contrasts with the more typical incremental budgeting that focuses on just the increase in a budget. With incremental budgeting, there is negotiation over how large an increase will be authorized. While incremental budgeting implicitly assumes that every department can spend what they spent the prior year and then some, ZBB requires justification of all spending, not just the increase from one year to the next.

ZBB argues that some departments might have a need for a 10 percent budget increase, while another might not need any increase at all. Some departments should even be cut, because they no longer have needs that justify the budget level of the previous year. As a result of this philosophy, ZBB is better at allocating an organization’s resources to the areas that have the greatest needs.

However, the evaluation of each and every item in each budget is a very time-consuming process. Some organizations use a rotating approach, with each department receiving a thorough ZBB review every three (or four or five) years, and incremental budgets in the intervening years.

ZBB not only requires justification of all costs in the budget, but it also focuses on alternatives. Information is collected into a decision package. This package provides the analysis of the program or department being evaluated. It contains broad information about why something is being done, the negative effects of not doing it, and the costs and benefits. One of the key elements of a decision package is a statement of alternatives.

ZBB requires evaluation of alternatives in a variety of ways. Different programs aimed at the same goal should be compared. Different ways of performing each given program should be compared. Different quality and quantities of each program should be compared. For example, if we could buy a top-model machine to make our product, or a middle-of-the-road model, ZBB requires explicit evaluation of the extra costs and extra benefits related to the top-model machine. By examining alternative approaches and the costs and benefits of each approach, managers are placed in a better position to make informed choices when allocating limited resources. Each alternative is ranked, with the manager giving consideration to the costs and benefits of the differing approaches. As a result, ZBB is a valuable budget technique.

**KEY TERMS**

Budget—a formalized (written), quantitative (in dollars) plan.

Uses of budgets—set goals; evaluate results; improve the effectiveness of decision making by planning ahead; improve communication and coordination.

Budget Preparation

* Preliminaries—an environmental statement should be developed to determine the position of the firm relative to customers, suppliers, and creditors. General objectives should be set, specific assumptions made, and measurable goals established.
* Forecasts—the essential ingredient for compilation of budgets is a set of forecast information. Generally, forecasters use such mechanical means as statistics and computers to project the past into the future. Managers must be aware that judgment should be used to modify forecast results.
* Departmental budgets—the organization budget consists of the aggregation of budgets from each department. The departmental budgets itemize revenues and expenses in detail.
* Workload level—volume of goods or services that the organization provides.
* Flexible budget—an operating budget for varying workload levels.

Fixed costs—cost that do not change as volume changes.

Variable Costs—costs that change in proportion to changes in volume.

**QUESTIONS FOR REVIEW**

1. What is a strategic plan?
2. What is a long-term plan?
3. What types of budgets are prepared annually?
4. What are some of the benefits of operating budgets?
5. What are the preliminary steps in budget preparation?
6. How can forecasting using curved lines help an organization keep inventory levels low?
7. What does workload refer to?
8. What is a flexible budget?
9. Using the assumptions in the chapter, prepare a flexible budget for the coming month for Finkler Corporation assuming that sales are either 36,000 or 44,000 units.
10. Assume that Finkler Corporation is budgeted to begin its year with $25,000 of cash. Further assume that revenues for the coming month (on an accrual basis) are budgeted to be $160,000. However collections from customers only expected to be $140,000. Expenses on an accrual basis are budgeted to be $164,000. The company expects to actually make payments of $150,000. Prepare a cash budget for Finkler Corporation for the coming month.
11. What is Zero-based budgeting?