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PART 1

The Foundation and Practice of Budgeting and Financial Management

A budget is an organization's operating plan expressed in monetary terms. A budget defines goals, outlines how operations are expected to be conducted, and sets performance standards. Actions are random without a plan or budget. A random action could be possible with unlimited resources, but in the face of limited resources and competitors seeking to steal customers, it is a prescription for failure. Budgets provide a framework to set and pursue goals and evaluate performance.

Budgeting encourages people to think about what they will spend before they actually spend their funds. The difference between budgeting and spending is as stark as the difference between being proactive and reactive. Budgeting requires individuals to determine where they want to be, how they expect to get there, and whether they can reach their goals with the resources at their command. Spending requires little more than reacting to events as they arise, and may be a viable strategy if one had unlimited funds. No individual, organization, or country has unlimited resources, so budgeting is needed to increase the probability of achieving goals.

Budgeting and financial management are often overlooked (or actively avoided) skills in the pantheon of management abilities; that is, they are often viewed as a technical activity best left to specialists. The chapter "Financial Planning and Management" introduces readers to the primary budgeting and financial management functions. The specialist view undercuts those who hold it, managers responsible for planning, organizing, leading, and controlling cannot fully complete their duties without financial competency. Financial competence is having the knowledge, skill, and ability to respond to issues and challenges to improve the economic performance of an organization. The managers' primary responsibilities are assuring effectiveness and efficiency, which cannot be achieved without financial information.

While we would hope that the people creating a budget have a thorough understanding of the systems they are working in, managers are often thrust into positions of authority without a clear knowledge of inputs, throughputs, outputs, and feedback mechanisms used in production. Budgeting provides the means to acquire this knowledge. Once managers have this knowledge, they can then assess what type of budget would provide the greatest support for the activities of their departments. Readers are introduced to five types of operations (cost, expense, revenue, profit, and investment centers) and five types of budgets (incremental, flexible, zero-base, program, and activity-based budgets). There is no one-size-fits-all approach that maximizes value; incentives matter, and managers should use the budgeting system that provides the greatest encouragement to the desired behavior.

The chapter "Accounting and Economics" discusses the obstacles (uncertainty, bounded rationality, and opportunism) to maximizing the value of an organization from a set of resources. Assigning resources to their optimal use is impeded by uncertainty. We often do not know what the best use of a resource is, and even if we know the answer today, it may not be the same tomorrow. While uncertainty recognizes that the future cannot be known, bounded rationality acknowledges that we may be less than clear on the best use of resources today. Individuals must work within their knowledge and experience, and their understanding of customer desires and production methods may be incomplete. Finally, opportunism recognizes that even with certainty and unbounded rationality, the inherent drive to improve one's self-interest often results in the pursuit of personal goals at the expense of others. The choice of a budgeting system should be made on the basis of its ability to minimize and control the conflicting goals of individuals, organizations, and society.

Accounting provides the essential foundation to measure success. The question of viability, that is, whether operations can be continued, is answered by the income statement, that is, whether total revenue is greater than or less than total costs. Solvency, that is, whether total assets are greater than or less than total liabilities, is assessed by the balance sheet. Understanding each is essential to determining how profitability and equity can be increased. Economics supplies the idea of opportunity cost, the recognition that everything we do or spend precludes other activities or purchases and maximizing value from resources requires that they be allocated to their best uses. Similarly, the idea of marginal decision-making recognizes that the return from resources devoted to an activity will decrease as the resources are increased. An understanding of accounting and economics is required to understand cost behavior and reach efficiency.

Organizational architecture and evaluation of department performance are key elements in this text. Managers should be accountable for only the things they control. Readers should understand that a cost center manager should be held accountable for the resources used and what they produce, while an expense center manager may be responsible for only the mix of resources used, given the lack of a clear output measure to assess efficiency. Accountability should also be different for managers charged with selling products (revenue centers); divisional directors who control product mix, output prices, and input mix (profit centers); and the C-suite, which sets goals and investment policy (investment centers). Budgeting should provide metrics that clearly and equitably measure the performance of different managers.

The chapter "Budget Incentives and Strategies" begins by recognizing the balancing of interests in market transactions that encourages efficiency among producers and discourages overconsumption among consumers. The chapter explores the incentives toward overproduction, inefficiency, and overpaying for resources in nonmarket systems, where the recipients of goods and services and the providers of resources are not the same. The chapter also talks about who participates in the budgeting process, what roles they normally fill, and what their behavior is. First, a typical budget cycle, or calendar, is provided to demonstrate when each participant enters and exits the process. Next, budget strategies are reviewed. The chapter focuses on activities and outcomes rewarded in the budget. Readers should recognize that individuals will attempt to optimize their well-being under any system, so the budgeting process and system need to be carefully designed and implemented to ensure individual interests are not pursued to the detriment of organizational objectives.

The chapter concludes by reviewing what a budget is and what it is not. A budget is a means to understand an organization, its goals and priorities, its operations, and its incentive structures. A budget is not an end in itself; the goal is not to create a financial plan but rather to facilitate the achievement of organizational goals. Budgeting seeks to obtain the greatest amount of output from a set of resources and can only reach its potential when all participants in the process understand what a budget is and how it can improve their performance as managers.

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CHAPTER 1

Financial Planning and Management

CHAPTER OBJECTIVES

1. Explain the prospective, concurrent, and retrospective phases of budgeting and their goals, purpose, and interrelationships.
2. Describe the roles played by senior management, operating managers, and finance in the budgeting process.
3. Compare the different types of budgeting systems and their foci.
4. Explain how the resource allocation process differs between for-profit, nonprofit, and public organizations.
5. Describe the major benefits of a budget.

Introduction

There are two types of managers, financial managers and nonfinancial, operating managers. Although the number of operating managers greatly exceeds the number of people working in finance, finance has a disproportionate hold on organizations. Operating managers oversee the primary activities in the value chain (e.g., inbound logistics, operations, outbound logistics, sales, and service) and are entrusted with ensuring the organization satisfies its customers. Finance is a support function that should facilitate the primary activities by providing employees interacting with customers with the resources and information they need to succeed.

The primary functions of management are planning, organizing, leading, and controlling (Robbins & Coulter, 1999, p. 11). Planning sets the big picture: what are the goals, strategy, and plans of a department or organization? Organizing defines the tasks to be completed: who performs each task; how, when, and where tasks should be performed; and who makes decisions? Leading is where plans and the organization are tested; managers should direct and motivate employees toward desired ends and resolve conflict. Controlling is the day-to-day monitoring and evaluation of results and the implementation of correction, when needed. Some managers believe that planning, organizing, leading, and controlling can be completed without reference to finance; however, no function can be conducted without financial information. A firm understanding of cost and revenue is essential to setting goals, an understanding of costs is vital to designing efficient work processes and allocating resources, and leading and control cannot occur without knowledge of whether the organization is on track to meet its goals.

The prominence of finance in organizations lies in the fact that all managers, whether trained in finance or holding a financial position, are responsible for how resources are employed. At the end of the day, bills must be paid, and everything operating managers do has economic implications, from the purchase and use of labor, supplies, and equipment to changing inputs, processes, and products. While managers may have intuitive reasons for proposing or implementing change, finance requires that managers explicitly define how systems will change, and quantify in dollars the degree of improvement expected. Finance provides systematized thinking about means and ends and a method of ordering information. Structured thinking is always preferable to undisciplined thought and rash action but can be intimidating to those unversed in its practice. Operating managers are often challenged by the financial method of organizing information because of their lack of training in accounting, economics, and finance.

If your job is to attend to patients in a nursing unit, run and report lab tests, clean rooms, or monitor government healthcare policy, you need to navigate financial waters. When planning change, it is insufficient to simply claim it will increase output, improve quality, or reduce costs. A financial case should be made that quantifies the cost of the change and the increase in output (or revenue) expected, the degree of improvement expected in quality, or the reduction in costs anticipated. Accounting not only establishes the rules of the game, it also *is* the language of business and all managers should be fluent. The text is designed to elevate your financial vocabulary and skills, increase your managerial effectiveness, and enhance your ability to understand and interact with finance professionals.

What is financial management? This question can be answered from two related but different perspectives. The first perspective is the specialist view encompassing people trained in and/or working in finance. Financial activities from the specialist perspective include planning and budgeting, financial reporting, capital investment decisions, financing decisions, working capital management, contract management, and financial risk management (Gapenski, 2012). Weston and Brigham (1978) define finance functions as raising and allocating funds and managing the use of funds, including ensuring the availability of cash to meet commitments.

The second perspective is that of operating managers, whose primary responsibilities are not finance per se but rather completing tasks under monetary constraints. The perspective pursued in this text is that of an operating manager with minimal financial training. The work of financial and nonfinancial managers overlaps in budgeting; therefore, operating managers must produce acceptable goods or services and remain within their budget to reach organizational goals and secure favorable performance reviews. The challenge facing operating managers is that although they are knowledgeable in their primary area of responsibility, they are often greenhorns in financial management.

It matters little whether a person is managing a pathology department, an auto assembly plant, a school, or a church; the person's expertise is probably not finance. Yet, each is responsible for economic performance. Likewise, most college graduates are often less than fully competent in financial management unless they majored in finance or accounting, and most never take a finance course. Yet, once they assume a managerial position, their performance will be determined by their **financial competence**. Financial competence is having the knowledge, skills, and ability to respond to issues and challenges to improve the economic performance of an organization. Managers are entrusted with resources that determine the cost of producing goods and services and/or the ability to generate revenue that shape customer satisfaction and the financial success of the organization.

The problem is that many managers do not understand how they contribute to the success of the organization. This confusion is the direct result of how students outside of finance and accounting are educated. Introductory healthcare finance courses cover the gamut of finance activities, that is, the seven functions noted by Gapenski (2012). This approach provides a 40,000-foot view of the financial topography but fails to bring students to a level of competency in *any* area of finance. Managers thus trained, and the untrained, face a rude awakening when they assume command of a department. Once in the trenches and responsible for running their area according to a budget, they begin to understand what they do not know about finance.

Perceptions on Budgeting and Budgeting Perspectives

The budget most managers inherit is simply a record of past expenditure. Managers are given a budget, but many have little knowledge of how the amounts allocated to various expenses were determined, and are expected to complete their work, while keeping expenses at or below budget. The starting point for the examination and mastery of financial management is budgeting. No part of finance looms larger in the day-to-day responsibilities of managers than creating a budget and responding to budget variances. A **budget** is a department's or organization's operating plan expressed in monetary terms. Budgeting is often a source of discontent among operating managers because of their lack of financial training and the impact of the budget on who gets what resources.

Budgeting competency requires that managers be able to (1) define the production system (the area where they are knowledgeable), (2) quantify expected operations in dollars (building a budget, the area where they are less knowledgeable), and (3) analyze actual results in light of the budget to determine where things went better or worse than expected (the area where they have the least knowledge). Budget construction and variance analysis are the two finance functions operating managers regularly work with, while opportunities to participate in capital investment decisions are rare, and financing and working capital management issues may never arise. In light of this reality, the text focuses on building a budget and comparing actual results with expected performance, so managers can more effectively complete their duties when they assume responsibility for a department, division, or organization.

The text covers all traditional financial topics, such as pricing, breakeven analysis, capital structure, and cost of capital, but does so from the standpoint of building budgets and managing operations. Budget construction and variance analysis, often covered in one or two chapters in finance textbooks, are comprehensively developed with data from actual organizations and the healthcare industry. The use of actual financial statements and industry statistics builds insight into the complexity of healthcare operations and points readers toward useful sources of data from which they can build their budgets and compare performance. (Chapter 15 provides an overview of the more rarefied topics, such as financial reporting, working capital management, contract and financial risk management, and capital structure and financial leverage, to complete the picture of financial management.)

Managers of cardiology programs, physician practices, clinical labs, and human resource departments face different budget situations. The manager of a cardiology program or physician practice may select what services will be provided, set the prices of those services, and determine the resources used to create those services. A lab manager may supply lab tests (a known quantity and quality), where he or she may have no control over prices or the quantity of tests preformed but is evaluated on their ability to stay within the budget. A human resources manager, unlike the lab manager, does not produce discrete outputs or outputs whose quality can be readily assessed. These differences argue against a one-size-fits-all budgeting approach. The goal of the text is to connect what a department does (and what a manager should control) with a budgeting system that facilitates management by providing insight and facilitating comparisons. Roles are clarified, conflict is minimized, and budget management is simplified when budgets are built that operating managers *and* their supervisors agree accurately estimate and fund the work expected to be done.

Budgets are often simply a bureaucratic exercise carried out by untrained and hostile managers to meet a directive set by some executive or accountant. A budget is constructed with little enthusiasm when it is seen as a bureaucratic exercise, another irrelevant task that delays the more pressing and important management of day-to-day operations. Managers put little effort into preparing their budgets when they believe their revenue and expense calculations will be ignored and their budgets may ultimately be set by accountants who have little knowledge of their departments and their operations.

Budgeting is often a contentious process in organizations, a contest for resources, where political power plays a large role in determining funding levels. Years ago, Moore and Jaedicke (1976, p. 555) attributed the negative attitudes toward budgeting to the fact that it is designed to be a restraint on action and spending and that few people welcome limits imposed on them by others. More recently, Libby and Lindsay (2010) reported the four main criticisms of budgeting: it consumes a lot of managerial time and the cost may exceed its benefit, it inhibits change, it is often disconnected from strategy, and it encourages budget gaming. These criticisms are legitimate, but they speak to how budgeting is used rather than what inherent flaws there are in budgeting.

Senior management, which has the most to gain from an effective budgeting process, is frequently hostile and dismissive of budgeting. Hostility arises from the nonfinancial members of the executive staff, who are intimidated by the accounting and budgeting processes and perceive the budget as an attempt by finance to increase its control over the organization. Among operating managers, the budgeting process is frequently seen as violating the **unity of command**: managers feel they must report to their direct supervisors for operational matters *and* to finance for budget issues.

Finance is partially responsible for cultivating the perception that it lords over other departments. Budget procedures are seen as arbitrary and obtuse and the finance staff aloof and unhelpful. The budgeting process is further undermined when senior management abdicates responsibility for accounting and budget matters and leaves subordinates to "work things out with finance." The "hands-off" approach makes it clear to subordinates that budget work is unimportant to their bosses and is performed solely to pacify finance. Managers in this situation effectively report to more than one superior and accordingly feel little commitment to the budgeting process. The resulting budget is designed to minimize conflict and contains trivial, if any, differences from prior budgets, and expenses are increased enough to cover expected price increases for resources, allowing operations to continue more or less as they have in the past.

Once finalized, the budget is put on the shelf—one more task accomplished. On-the-shelf budgets are not integral to the work of employees and are not used to control, evaluate, or improve operations. This is the inevitable result of budgeting where few employees understand the role and functions of a budget: the budget is simply an aggregation of numbers. This all-too-common and unfortunate result can be avoided if senior management demands more from budgeting and is willing to supply the resources necessary so that all managers can fully contribute to the budgeting process.

Budget Perspectives

Budgets are designed and should be used with three time periods in mind: the future, the present, and the past. The future (or prospective) stage is where the primary concern lies and often produces a dysfunctional budgeting process that spends disproportionate time predicting future output and prices and too little time analyzing what actually occurs. Hours are spent determining the amount of funding needed (what resources are required) to carry on operations in the upcoming year, but once the budget is finalized and the fiscal year begins, it has little impact on day-to-day activities. Using a budget primarily to predict future revenues and expenses ignores and negates its true function—a tool to guide and control operations. It is the responsibility of senior management, finance, and operating managers to ensure budgets are not a yearly exercise in foretelling the future to be prepared and forgotten.

The tendency toward dysfunction is encouraged by the budgeting system employed: many organizations use **incremental budgets**, which encourage overestimation of output and the resources needed to complete work. Incremental budgets are constructed by adjusting historical expenditures for inflation to create future budgets. Other budgeting systems lessen the dysfunctional tendency of incremental budgets, but many people do not realize how systems' performance may be predetermined before the budgeting process begins. *Every system is perfectly designed to achieve the results it produces*—the choice of a budgeting system may have more impact on employee performance and production costs than any other factor. Does your budget encourage effort, economy, and innovation, or does it produce shirking, waste, and the status quo?

The value of a budget is maximized when the present, past, and future are simultaneously considered. The operating results of prior years and the current performance should inform the budget but not dictate future expenses. Present operations should be evaluated in terms of past performance and future needs: what will customers want tomorrow, next month, and next year? Budgets should enable managers to understand where they have been and how they are performing and guide them to where they want to go; "things have always been done this way" does not mean future operations should follow the past.

The budget is an organization's map to the future. Once a budget is completed and the operating year begins, the budget should serve as a management guide (the concurrent budget role). **FIGURE 1.1** highlights the three budgeting perspectives prospectively; the budget asks what resources should be consumed to produce a given quantity of goods or services? After the fiscal year starts, managers should use the budget to determine whether the expected amount of resources is being consumed. Is the plan being realized? The answer should dictate whether present practices are continued (when on target) or whether investigation is needed to determine why things are not going according to plan (when over- or underbudget). Analysis should determine when corrective action is required and what actions are required to obtain the maximum value from resources. The link between the budget and operations is frequently missed.

Future (Prospective)	**Present** (Prospective)	**Past** (Retrospective)
Estimation of budget year revenues and expenses Resources that should be consumed	Facilitation and control Resources being consumed	Evaluation (accountability and incentives) Resources consumed
Beginning six months before the start of fiscal year	Twelve months, the fiscal year	Concluding six months after the end of the fiscal year

FIGURE 1.1 Budget Perspectives

Managers often do not see how budgets can facilitate day-to-day control, but rather see them as a burden to struggle against, that is, "I get work done despite my budget."

After the close of the fiscal year, the budgeting process should retrospectively examine performance to determine whether operations could have been completed more effectively or efficiently. **Effectiveness** measures whether the organization met its goals. Were the goods or services produced willingly purchased by consumers? Were the consumers satisfied with the goods or services after purchase? **Efficiency** measures the amount of resources consumed in creating a product. Was the minimum amount of resources employed, or did the organization use more or pay more for labor, materials, equipment, and/or buildings than was necessary to produce its output? In the long run, organizations must be effective, producing satisfied consumers, and as efficient as their competitors. Inefficient producers may produce desirable products, but if their costs are too high, they will find themselves driven out of business by nimbler competitors.

Retrospective analysis assists managers in designing better systems that encourage employees to strive for the organization's goals. It is vital to see budgets as more than prospective exercises in estimating future revenues and expenses. The whole is greater than the sum of its parts; organizations lose most of the benefits budgets can provide when the concurrent or retrospective elements do not establish accountability or incentives.

Budgets can be outstanding tools that reflect and communicate the goals of an organization; increase understanding of the organization and its operations, products, and customers; and identify areas where improvements can be achieved, while providing incentives for employees to improve. Properly used budgets are the essence of management, defining goals (planning), directing resources and processes (organizing), influencing employees and customers (leading), and identifying when change is needed (controlling).

How does a tool that offers so much become an annoyance to those who use it? Part of the answer is that managers and employees do not come to budgeting naturally but are forced to construct budgets and respond to monthly variances as part of their job. Annoyance often results when knowledge regarding the use of a tool is lacking. Notice the number of people who damn technology because they have not learned how to use it. Personal computers, cell phones, and programmable thermostats offer a multitude of benefits if one takes the time to understand their uses and operations, but too many people believe they are too busy to read the instruction manual, and fail to obtain the benefits of the technology and waste time attempting to use it.

Like technology, the key to budgeting is an understanding of its uses and processes. Education is the answer, but operating managers often have little understanding of why budgets are created or how they should be used. People trained in medicine, engineering, theology, etc., cannot be expected to understand the complexities of finance, but these are exactly the people called upon to prepare and execute budgets. Increasing the understanding of the financially uninitiated on the fundamentals of accounting, economics, and budgeting will make them more effective managers.

Strategic Planning, Operations, and Budgeting

Reinforcing budget frustration is the misperception of senior management, which is trained to think about the organization as a whole, and financial professionals, who focus on resource constraints but often fail to recognize the complexities and demands facing operating managers. Senior managers see themselves as planners or futurists, while accounting and budgeting personnel find themselves delegated to be the financial watchdogs of the organization. Senior management is responsible for ensuring the current and future success of the organization. Senior executives must see "the big picture" and provide the vision of where the organization will be in 5 years or more. Finance is responsible for determining whether the organization has sufficient money to continue operations and meet future needs, while operating managers want enough resources to complete their daily tasks.

Frustration is inevitable when senior management and finance attempt to dictate output levels *and* costs to operating managers. A prime benefit of budgeting is to reconcile the department or process view of operating managers with the broader goals and vision of senior management and the constraints and trade-offs of finance. Each group understands a different aspect of the organization, and all views are necessary for success. Operating managers should not be allowed to determine their expenses without reference to the larger organizational goals and constraints, nor should senior management or finance, who may not understand production processes, dictate costs. A useful budget synthesizes the forward-looking, functional, and financial perspectives and provides greater understanding to senior management, operating managers, and finance of the other perspectives.

As seen in **FIGURE 1.2**, all three groups should focus on where their responsibilities overlap (i.e., the core). The core is where goals are connected to resources (whether goals can be achieved within the organizational constraints) and an action plan (how the goals will be achieved, and what processes will be used). Organizations generally do not provide adequate training to help operating managers understand the goals, structure, and processes of budgeting. Organizations commonly provide managers with only enough information to prepare a rudimentary budget and provide trifling responses to budget variances. Operating managers frequently have neither the time nor the information to see the big picture, the constraints on the organization, how their operations fit into the organization's goals and vision, and whether their budget and performance are treated equitably relative to other departments. However, managers quickly learn how to work budgeting systems to secure their personal goals. It is easy to see that when people perceive constrained spending, unrealistic performance expectations, and resources given to others, they harbor resentment against the people and processes that nurture these perceptions and manipulate the system for their own benefit.

Education and openness are key to a productive budgeting process. Operating managers

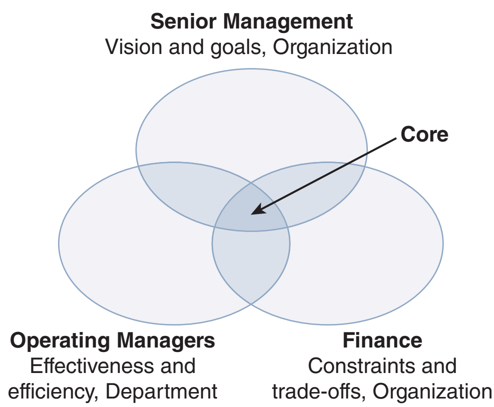

FIGURE 1.2 Interrelationships between Senior Management, Operating Managers, and Finance

should see themselves, their departments, and their budgets as integral components to the success of the organization. They should understand the organization's mission, its chosen means to achieve the mission, the resources committed to those means, the tools used to monitor performance, and the incentives designed to ensure follow-through, a rapid response to problems, and process improvement. Problem solving and process improvement require timely information to understand and control operations.

Timely and accurate information is necessary but insufficient to ensure managers and workers pursue goals in the best interest of their employers; they also require motivation. The satisfaction of doing a job well is seldom enough to encourage high performance when managers and workers are aware that nonperformers receive similar compensation. There must be some added incentive (praise, advancement, salary, etc.) to encourage employees to excel; the budget should provide the basis for recognizing those who perform above and below par. Timely and effective action on financial information is essential to achieve organizational objectives and establish the credibility of management and the budgeting process.

Budgets should identify potential (what an organization should be able to produce with a given set of resources), define accountability (who is responsible for meeting goals), and provide appropriate incentives to individuals to strive toward this end. The continuing demands for government subsidies for Amtrak provide a case in point of lack of accountability. In 1997, Congress passed a law requiring Amtrak to cover its operating expenses by December 2002; operating losses in 2002 were $1.18 billion. In 2002, Amtrak officials said the 1997 breakeven dictate was impossible, and they knew it when they accepted the goal. What does this say about the credibility of Amtrak's oversight? It indicates Amtrak's management never expected to be held accountable and explains why Amtrak has never covered its expenses since its formation in 1971. Amtrak's operating loss in 2016 was $1.080 billion, and proceeds from federal paid-in capital were $1.530 billion (Amtrak, 2016). The larger issue is what control society has over operations whose managers expect ongoing public subsidies.

Accountability is a bad word to those who believe they are subject to unrealistic demands or who have had the luxury of being unaccountable. Everyone would like to be given a task without a resource constraint; that is, we would like jobs where we could consume as many resources as we want. If everyone acted without economic restraint, it is easy to see resources would be squandered, less goods and services would be produced, and the world would be poorer. Proper oversight of resources requires a standard of appropriate use and incentives to conserve resources.

A properly constructed budget is the antidote to the empty and often mindless calls for reduced spending; it should tell managers whether it is possible to produce a specified level of output, given the allotted resources, before production begins. Budgets more often than not make too generous resource allocations rather than too low or efficient resource allocations. Accountability makes sense only when an efficient amount of resources is provided. Managers who find it too easy to meet their budgets and those who find it impossible have little respect for the process or those involved in it.

Budgeting quantifies in dollars where managers intend to go (goals), how they plan to get there (an operations guide), and how much it should cost to get there (resource constraints). Budgeting should serve planning and operations by informing goal setting and providing standards against which operations can be evaluated and managed.

Who Does What?

Senior management sets short-term goals and provides the long-term vision for the organization, operating managers run day-to-day operations, and finance provides accounting reports and ensures access to resources. Senior management and operating managers direct and motivate employees, and budgeting is essential to setting goals (are they feasible?), assessing performance (is the organization on-track?), and establishing a climate where employees strive to achieve organizational goals (are incentives in place to encourage employees to produce the best product at the lowest cost?). Operating managers and accounting provide the day-to-day structure to assess and control performance. Does output meet the targets set in the operating plan? Is the product selling as expected? Are defects at or below targeted levels? Is production on schedule? Are final products delivered to end users at the time promised? Have costs been minimized? Are customers happy? The intersection of senior management, operations, and finance is a budget that provides quantitative targets to assess these questions and serves as a guide for adjusting performance; it is the essence of organization, leadership, and action.

Senior management should provide the mission, vision, and goals for the organization before a budget is constructed. The budget is the organization's map to its desired destination, the success of which requires managers find and follow the limited number of routes that make the most of the opportunities available. The failure to plan, like randomly selecting a road to arrive at a desired destination, is unlikely to carry an organization to success. Budgets do not ensure success, but the failure to specify where you want to go and how you intend to get there increases the likelihood of failure.

Senior management's role is strategic decision-making, while operating managers are tasked with making tactical decisions. **Strategic decision-making** determines what an organization should be, where it is heading, and how it should get there. **Tactical decision-making and action** is the day-to-day work required to keep the organization on track, achieve its goals, and use resources as planned. Strategic management broadly describes what the organization hopes to accomplish; tactical management assembles and coordinates resources to achieve the mission.

After an organization's strategies and goals are formulated, the role of budgeting is to determine whether the goals are feasible, given its resources, and assist managers in identifying the best means to achieve those goals. Some people believe that the role of finance is simply to provide funds for operations and that finance should not impose its view on the organization that revenues must cover costs. This view is strong among nonprofit and public employees, who believe they pursue noble ends and should be exempt from financial constraints. This view is as wrong as it is strongly held; every organization must cover its expenses to survive. Organizations must generate sufficient revenues to cover their costs by selling goods and services or recoup any deficiency through voluntary (donations, gifts, loans, etc.) or involuntary (taxes and subsidies) sources of funds, or they cease to exist.

Employees often become upset when lack of funds kills a favored project or requires expenses to be lowered and interpret this as an unwarranted financial intrusion into operations. These people are either unable or unwilling to see the burden money-losing programs place on other departments and the organization's viability. Given limited resources, everyone should understand the need to be efficient and work within resource constraints. Plans and operations must be adjusted to the resources the organization can draw upon. Finance would be negligent if it allowed managers to start down a path they cannot complete because of insufficient resources. Unfortunately, the bearer of financial limits, like the bearer of bad news, seldom gets an enthusiastic reception.

When sufficient funds are available to fulfill a strategy, budgets should guide the management of resources on an ongoing basis (facilitate operations) and evaluation of performance (management, use of resources, and achievement of goals). **FIGURE 1.3** demonstrates

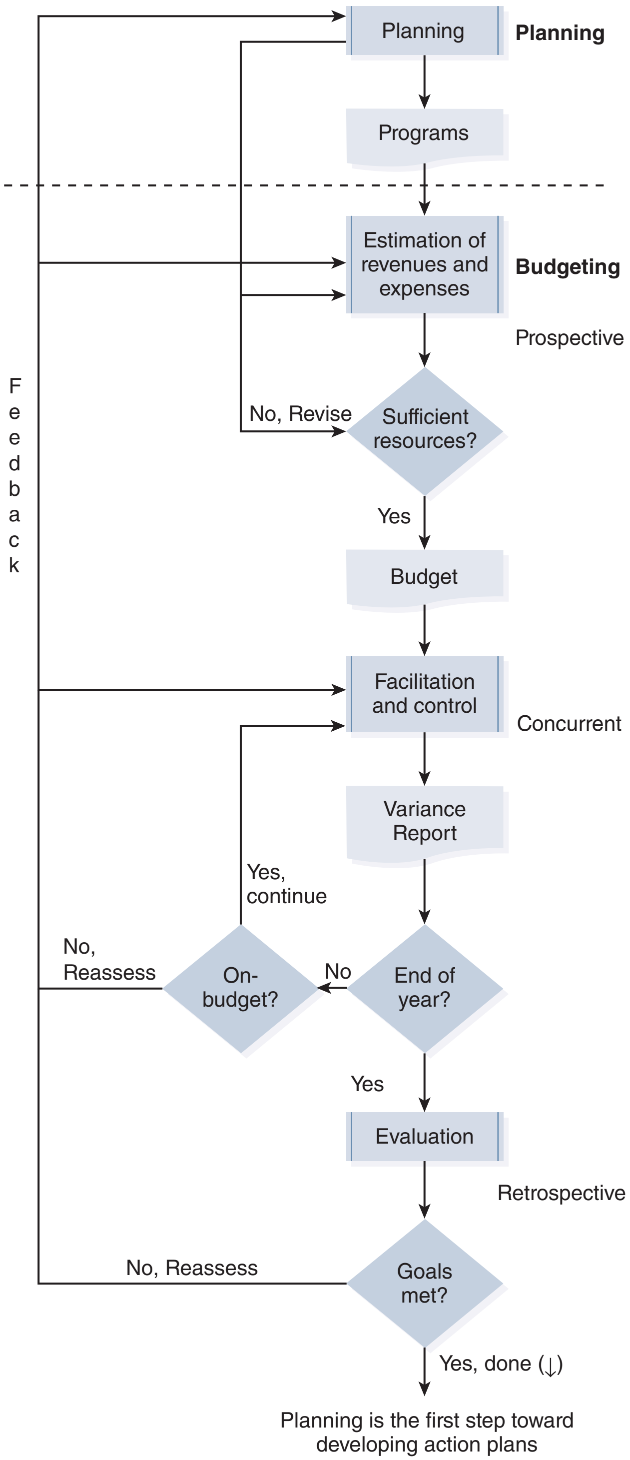

FIGURE 1.3 A Budgeting Flowchart

Cleverley, W. O., & Cleverley, J. O. (2018). *Essentials of Health Care Finance* (8th ed.). Burlington, MA: Jones & Bartlett Learning the relationship between the planning process and the budget stages and the need for feedback to ensure each part of the process communicates with and improves earlier functions when deficiencies are identified. To operate effectively, each stage in the budgeting process requires different perspectives, skills, and information.

Planning and determining organizational goals is the responsibility of senior management and precedes the formal budgeting process. Planning defines what programs will be pursued, what work should be done, how much output is expected, and when it will be produced. Budgeting, being subordinate to planning, communicates back to the planners whether the organization has sufficient resources to carry out the plan. If sufficient resources are not available, plans should be altered so that they can be accomplished with the resources available to the organization. If a plan can be achieved with the organization's resources, the budget communicates to the operating managers responsible for carrying out the plan what is expected of them and what resources they will have to fulfill their tasks.

Like a thermostat, a budget evaluates whether an organization is "too cold" (spending too much for the output produced) or "too hot" (producing too much output, given its resources) and signals the "heating and air-conditioning system" to provide cooling or heat. Organizations running cold should reduce input use, and those running hot should commit more resources to maintain the quantity and quality of output. When the temperature falls within an acceptable range, the heating and air-conditioning system turns off. Unlike a thermostat, however, a budget monitors multiple criteria and should provide managers with detailed information on a range of outcomes to allow them to adjust operations as needed. The goal of planning and budgeting (estimation of revenues and expenses, facilitation and control, and evaluation) is to improve the effectiveness and efficiency of production systems.

Organizations exist to serve the desires and needs of owners, customers, employees, and the communities in which they are located. In for-profit organizations, the main goal is to maximize the wealth of the owners, whether they are mom-and-pop operations or large multinational enterprises with millions of shareholders. While maximizing owners' wealth is the goal, the means to greater wealth require these organizations to provide goods and services at prices that attract and retain customers. The result, as Adam Smith noted, is that individuals pursuing their own interests serve the public more effectively than if they had consciously set out to assist others (1977, p. 477).

Planning is the first step in developing action plans that maximize the value of the organization. In sole proprietorships, mom and pop are the strategic planners; they not only are employees but also determine the direction of their business goes. If mom and pop select the right goals and follow an effective action plan, they reap the benefits of their foresight and ability to carry out the plan. If they choose the wrong goal or cannot manage the plan, they lose money and may end up bankrupt.

In large, for-profit corporations, ownership and management are divided. Mom and pop may own 10,000 shares of Google, but they are not going to be directly involved in setting Google's goals or strategies. These decisions are delegated to professional managers, who are responsible for protecting the interests of shareholders and may be accountable if operating results fall short of expectations. The performance of for-profit corporations is judged by the equity and debt markets. Organizational goals, plans, and performance are followed by fund managers and bankers, and organizations that cannot attract and retain customers, manage resources, or grow as rapidly as they led their investors to believe find themselves with falling stock prices and limited ability to borrow money. These organizations may cease to exist unless improvements are made.

The concept of ownership is clouded in nonprofit organizations and public enterprises. Who exactly owns these organizations? Who should benefit from their operations? How is managerial performance evaluated and controlled? While ownership and control in nonprofit and public organizations may be unclear, the planning process and the goal of maximizing organizational value are the same as for-profits. Nonprofit and public organizations are owned by the community and should be run for the benefit of the community (versus private inurement of individuals). Managerial performance should be judged on how well the managers meet the organizational mission; while this is harder to evaluate than the simple objective of maximizing profits, performance is still evaluated by the people who provide funds. In the case of nonprofits, these will be philanthropists and/or lenders, and in the public sector, the executive and legislative branches of the government, taxpayers, and bond markets.

Regardless of ownership, managers must determine why the organization exists, what they hope to accomplish, and how they are going to accomplish their goals. Strategic planning should be a continuous process of decision-making (versus an episodic goal designation process) based on how well managers achieve current goals, given changes in the operating environment and control over resources. The budget should report whether goals are achieved and whether output, revenue, and expense projections are realized. Deviations from the operating plan require investigation: What internal or external factors changed to prevent actual expenses from meeting budget projections? Were budget deviations attributable to uncontrollable events, or were they due to the action or inaction of management? Budgets should assist in identifying uncontrollable factors and feeding information on performance and exogenous events into the planning, facilitation and control, and evaluation processes. Budgeting is a crucial link between an organization's achievement and its future.

The first step in strategic planning is defining the organization's **mission**. The mission provides the broadest and simplest answer to the question of why the organization exists. What is the organization's reason for being? The mission determines who will be served and what goods and services these customers or clients want. Understanding the needs and desires of potential consumers should guide senior management in determining what the organization should do: what goods and services to produce and how many of each to produce.

Looking inward, senior management must ask what owners want the organization to be. Should the organization strive to meet the demands of a broad market, or should it focus on a subsegment of a market? Hospitals sponsored by religious orders may choose not to provide services they believe conflict with their beliefs, despite a demand for those services. Senior management and owners of GE saw its future in high-tech products and elected to move out of financial services and home appliances to concentrate resources on an energy-centric strategy. An organization's mission should guide strategic and tactical decision-making and the behavior of its employees.

Unfortunately, the clarity of a mission is often lost when managers attempt to put these ideas into a mission statement. By attempting to be all things to all people, mission statements often degenerate into overly broad and generic statements that fail to define the organization or its goals. Too often, a mission statement is little more than an overly ambitious and ambiguous public relation statement: "We want to be number one in <name of field>," or "We want to make the world a better place by <providing a good or service>." Instead of inspiring or motivating employees, these statements appear as banal as answers delivered from memory by beauty pageant contestants.

A second problem arising from a primary appeal to external constituencies is that the mission statement may fail to provide guidance to internal constituencies. A mission statement that does not provide guidance is not taken seriously by anyone (if it is even known) in the organization. Effort expended crafting a meaningless mission statement that does not define goals or standards by which employees can measure and assess their performance undermines an organization rather than strengthening it. In extreme situations, the quest for a mission statement encourages dissension or indifference. Employees are divided between those seeking realistic and useful direction and those seeking an "all things to all people" missive that cannot guide decisions or actions.

Some people argue that asking for specificity from an instrument that must be broad misconstrues the role of mission statements. The practical problem is that mission statements are sold as essential to the organization's existence but employees frequently see them as irrelevant. An irrelevant mission statement undermines an organization's management, goals, and action plans. At a minimum, a mission statement should provide guidance when conflicts in goals and vision arise and resource limits are encountered. When all things are not possible, which alternatives should be pursued and what should be abandoned? Which of the available alternatives best fulfill the organization's mission and vision? It is not what the mission is but rather what the mission does that is important. The mission statement should unify the organization and guide operations; if it does not, it should be rewritten.

The next step requires senior management to translate the mission into goals. Goals define the operation: who will be served, what products and services will be produced, and what is success? Employees should know who they are expected to serve (types of customers), where operations will be provided (service areas: local, regional, national, or international), and what goods and services will be provided to customers and markets. Management should know whether customers can be provided with goods and services at prices they are willing and able to pay, while providing an adequate return to the people who supply the organization with resources. After goals are defined, concrete plans of what is expected must be developed (**TABLE 1.1**).

Programs are the third and final step in the planning process and the first step in creating a budget. The mission and goals are used

TABLE 1.1 Strategic Planning Examples

	Nonprofit/Public	For-Profit
Mission	Serve the poor	Maximize shareholder value
Goal	Reduce infant mortality	Concentrate efforts on high-profit, high-growth markets
Program	Build and staff a 10-bed NICU. Establish community health clinics in areas A, B, and C	Expand personal electronics product line—international
		Expand consumer finance offerings—domestic

to create action plans that specify how objectives will be achieved. Programs specify what the organization will do: who will be served, how many customers will be served, how customers will be served (the resources needed to accomplish the desired tasks), what markets the organization will operate in, what types and quantity of output it will produce, and what scale of operations is needed to produce the specified output.

The planning process starts with the mission and ends with specific programs. The three steps in planning (setting the mission, goals, and programs) define what managers expect in the budget year. The role of budgeting is to determine whether plans are achievable: does the organization have sufficient resources to operate on the scale envisioned? Budgets do not set direction but assess the probable financial consequences of the directions considered; they do not veto higher-level decisions but, rather, attempt to ensure sufficient resources are available to pursue the chosen goals.

Sun Tzu, more than 2000 years ago, noted in *The Art of War* (c. 400 BCE) that success hinges on planning: "The general who wins a battle makes many calculations in his temple, here the battle is fought" (p. 26). To mount effective action, leaders must understand the resources needed, their cost, and where funds will be gathered—planning must be carried to the level of line item budgeting to ensure success. The following proverb describes the result of failing to pay attention to small but vital details:

> For want of a nail the shoe was lost.
>
> For want of a shoe the horse was lost.
>
> For want of a horse the rider was lost.
>
> For want of a rider the message was lost.
>
> For want of a message the battle was lost.
>
> For want of a battle the kingdom was lost.
>
> And all for the want of a horseshoe nail.

The role of budgeting is to facilitate the achievement of chosen goals, and the first step in the budgeting process is to determine the resources an organization needs to meet its goals. Budgeting translates programs into dollars and cents. What types of resources are required? How many of each are needed to fulfill the programs expected? What will the resources cost, and does the organization have sufficient funds to purchase the resources? Planning supplies a set of programs to guide the estimation of revenues and expenses in the budget year.

The Budgeting Process

The first job of a budget is to quantify the revenues and expenses expected from the projected programs, that is, estimate future cash inflows and outflows. The operating plan should quantify expected output: What does senior management expect to produce and in what volume? What production methods will be used, and how much revenue is expected from the sale of output? With information on expected outputs and volume, managers can determine the types and amount of resources they need to produce the output and, given expected input prices, estimate the total cost of those inputs in the budget year. The key question is, will the organization have sufficient revenues (inflows) to cover its costs (outflows)?

Economics poses three fundamental questions: (1) what will be produced, (2) how will it be produced, and (3) who will receive the output? Budgeting is managers' answers to these questions. The first two questions are answered by planning and operations. The third speaks to customers and clients and sources of revenue. Where will money come from to pay employees, purchase supplies, and use equipment and facilities? Will funds come from market transactions (i.e., customer payments, donations, and/or government grants)? When donations and grants are available, will goods and services be offered at a subsidized price or at no cost to clients? Budgeting is a systematic process tying revenues to expenses and the main tool managers use to determine whether the organization can survive, given its revenues and production costs.

Operating managers often only see their own expenses, and their departments may not produce revenue. It is the job of the budget office to summarize departmental budgets into a **master budget** that reports total budgeted expenses and revenues to determine whether the operating plan is financially feasible. If the organization has insufficient resources to cover its projected expenses, the revenue shortfall must become feedback to planners to decide whether to reduce the number or scale of programs in order to match the organization's ability. It bears repeating that the role of finance is not to decide what to produce or the number of units to produce but rather to assess whether the operating plan is feasible. It is the job of senior management to decide what will and will not be attempted when resources are limited. When financial infeasibility is not conveyed to planners or planners ignore resource constraints, the organization is set on a path that can only lead to failure—attempting to do too much with too little.

Estimation of Budget Year Revenues and Expenses

Economics holds that the primary problem facing humanity is unlimited needs and desires and limited resources to produce the goods and services we want. Limited resources and unlimited desires are analogous to the sources and uses of funds in organizations. Organizations must have sufficient revenues to cover operating costs. There are unlimited ways in which organizations can spend money to improve or expand their output, but are customers or others willing to pay for these activities? Organizations could expand to serve new markets, but are resource suppliers willing to pay the cost necessary to produce additional goods? If existing customers, philanthropists, or taxpayers are unwilling to pay for expanding output or enhancing goods and services, then neither increased output nor improvements should be undertaken. The role of budgeting is to prospectively determine whether production costs can be recouped.

The estimation phase is integral to planning as it attempts to discern what an organization can and cannot do. The first step in the estimation process determines the relationship between revenues and costs: will a program be a net source of funds, generating more revenue than its costs, or a use of funds, with costs exceeding revenue? When costs are not covered, budgeting does not categorically reject the plan or programs but asks where funds will come from to ensure the long-run survival of the organization. Do some programs produce sufficient excess revenue over expenses to allow other programs to operate at a loss? Can other funds be raised to support programs where expenses exceed revenues? Organizations can survive with one or more money-losing programs if they have other sources of revenue, but no organization can survive over the long run if total expenses continually exceed total revenues.

The relationship between revenue and expenses is a question of value: is output perceived to be worth more than its production costs? Value is created when people are willing to pay more for a good or service than its production cost. Resources are squandered when people are unwilling to pay production costs and production occurs anyway. The resources used to produce low-valued output should be employed in areas where the inputs would produce more highly valued goods or services that people would willingly purchase. Agricultural surpluses and below-cost inventory reduction sales are two examples where the world would have been better off if the resources used to produce excessive amounts of milk, grain, and consumer products had been used to create goods and services for which there is insufficient supply.

A simple miscalculation is one reason products are created in greater abundance than desired. Management could overestimate the demand for a consumer good or service or underestimate production costs. In either case, customers may be unwilling to pay production costs. Another reason for overproduction is that some people benefit when the value of output produced is less than the cost of resources consumed. The first group is input suppliers, who receive their wages, interest, or rents, even if products go unsold or unused because no one is willing to pay a price that covers cost. The second group is clients, who receive free or subsidized goods and services and are unconcerned with total production costs. Employees and subsidized consumers ask, “Is what I’m receiving worth more or less than my cost?” Employees ask, “Is my salary greater than or less than the value of my time?” Clients ask, “Is the benefit I receive from a subsidized good worth what I have to pay for it?” Individuals typically do not ask, “Is the good or service worth at least as much as the cost of resources consumed to produce it?” but only ask, “Is it worth more than I have to pay for it?” Subsidies alter market transactions and benefit the workers and consumers of goods and services that are distributed free or below their production costs. Debates on sports arenas are a case in point. Team owners, players, and fans desire public-subsidized arenas. But do sporting facilities create value, and is the benefit to society, not just owners, players, and fans, worth the hundreds of millions or billions of dollars required for construction?

After determining total costs, budgeting asks the financial feasibility question: “Will revenues cover costs?” We want to know *before* resources are purchased and funds are committed whether costs can be covered. Programs specified in the planning phase are the primary input to estimates of resource needs and cost. The budget should determine whether an organization can afford the inputs required to produce the planned output and where funds will come from to purchase resources.

There are only three parts to a budget: output, revenue, and costs. The responsibility of planners and the budget office is to prepare an accurate output forecast, that is, the type and quantity of output expected, so that operating managers can construct accurate expense budgets. The task of estimating revenues may fall on the operating managers or the budget office. If the organization is divided into revenue and profit centers, operating managers may be responsible for revenue projections. But in many cases, revenue estimates are the responsibility of marketing or finance. Revenue estimates are built on projections of future sales and price increases. Sales, units sold, and the price at which output is sold are impacted by the degree of competition in the output market, consumer demand, and regulation. Other revenue streams, such as donations, grants, investment income, and loans, must also be estimated and incorporated into the budget to determine the total resource constraint.

Costs are typically estimated by department managers who understand both their production processes better than anyone else in the organization as well as the costs of resources needed to complete assigned tasks. The job of the budget office, after specifying the quantity of output expected, is to provide managers with guidance on cost increases, the predicted prices of inputs in the budget year, and specify budget procedures and deadlines.

The resulting budget is a specification of the type and number of goods and services expected to be produced, the revenues associated with the sale of these outputs plus other revenues, and the expense associated with acquiring inputs, if not the physical quantity of each input needed. The budget is the operating plan defining the cost of resources expected to be consumed and the way these expenses will be financed. There are two possibilities: revenues are greater than or equal to costs, or revenues are less than costs. If projected revenues are greater than or equal to costs, the estimation process may be complete. The completed budget can be sent to senior management and the board for approval, and if no changes are needed, the budget is complete.

If expenses exceed revenues (or a higher profit is desired), managers can continue to plan the same amount of activity and attempt to reduce cost (is there fat in the budget?), raise revenue (can higher prices be charged?), or revisit the planning process to reduce the scope of activities to be consistent with revenues. When revenue shortfalls constrain operations, budgeting is an essential tool to refine (not direct) the operating plan by providing timely and relevant information to senior management to affirm the organization's core objectives and focus efforts. The budget should define the extent of the revenue shortfall and provide options so that senior management understands the trade-offs faced. A third option may be to run an operating deficit, identify where additional funds to cover the costs (such as selling assets or soliciting loans or subsidies) will come from, and send the unbalanced budget for approval. Running a budget deficit is a short-term alternative and cannot be continued over the long run—no organization can survive if its costs continually exceed revenues.

Facilitation and Control

After the budget is approved and all parties agree that the plan is achievable and should be implemented, the second stage of budgeting is to operate according to the plan. The budget specifies where the organization will be if its projections of output, prices, and performance are accurate (the budget plan is met). If revenues just cover expenses, the organization will be no worse or better off than it was in the prior year. When revenues exceed costs, the organization's wealth increases and it will be more capable of achieving its mission. Organizations with increasing wealth can purchase more and/or better resources, expand output, or pursue other endeavors. When costs exceed revenues, accumulated wealth is consumed, and if costs continue to outstrip revenues, the organization will have to reduce its scope of programs and may eventually be forced to terminate operations. Given the necessity of covering costs over the long run, it is essential that managers use the approved budget as an operations guide. Failure to keep costs below or on budget weakens the financial strength of organizations.

For a budget to be an operations guide, it must clearly define output targets and resource limits so that managers can determine whether they are efficiently accomplishing their tasks. If department functions are not met or are being inefficiently achieved, the budget should be the basis for determining why this is occurring and how to correct the situation. Performance information must be delivered timely to managers to enable them to adjust operations as needed. Typically, managers receive monthly variance reports comparing actual and expected costs of operation. Variance reports should provide sufficient information for managers to monitor input usage and output, pinpoint the causes of variance, and adjust input consumption to meet budget standards for those inputs they control and to explain the variance for costs that cannot be controlled.

The job of managers is to effectively and efficiently produce goods and services, but before this can happen, managers must design goods and services that meet the needs and desires of consumers. Second, these products must perform at the level desired by customers *and* be offered at attractive prices. The desire of customers for the best product at the lowest price demands efficiency. Efficiency requires that no more resources be used than absolutely necessary to produce a good or service and the output be of sufficient quality to satisfy consumer expectations, industry standards, and/or government regulations. Producing low-cost and low-quality goods or services that no one wants to purchase is neither effective nor efficient. In health care, restoring a patient

TABLE 1.2 Performance and Sustainability

	Effective	**Ineffective**
Efficient	Long-run sustainability	Unsustainable
Inefficient	Short-run sustainability	Unsustainable

to health is the goal; it is pointless to provide healthcare goods and services at minimum cost if they do not improve the health of the patient. On the other hand, restoring health, while consuming an inordinate amount of resources, is a path to failure. Successful organizations operate in cell 1 in **TABLE 1.2**; they are both effective and efficient.

Effectiveness and efficiency may or may not occur together; organizations may be efficient but ineffective (cell 2), that is, producing a good or service at the lowest-possible cost that no one wants or is willing to pay for. As customer dissatisfaction grows, securing continued patronage will be difficult. An effective but inefficient (cell 3) organization produces a good or service that fulfills people's needs or desires but consumes too many resources. People want the good or service but may be unwilling or unable to pay the price required to obtain it. The organization may succeed in the short term, but its customers may switch suppliers as soon as a competitor emerges that produces the same outcome at a lower price. Finally, an organization may be ineffective and inefficient (cell 4): it produces high-cost goods and services that no one wants. This is the worst of all worlds and threatens the short- and long-term viability of the organization. The only viable position for an organization is to be effective and efficient; the other possibilities do not meet customer demands and/or consume too many inputs in satisfying consumers. Long-term success in markets requires an organization to deliver the best product at the lowest price. When market forces are absent, regulation is used to protect customers from price gouging and defective products.

Regardless of whether markets or regulation impose control on an organization, budgets are the primary internal mechanism managers use to allocate resources and evaluate their use. Monthly variance reports (Chapter 11) assess performance, but evaluation cannot be reduced to "Is a department or organization meeting its budget?" A major consideration in using variance reports is identifying controllable and uncontrollable costs. It makes no sense to hold managers accountable for costs beyond their control; effective budgeting systems concentrate the managers' attention on resources they can and should control.

If actual expenses are running ahead of the budget, what does this tell us about performance? It could be that the operating manager is not performing well, it could indicate problems in the budgeting or planning process, or it may be the result of unforeseeable and uncontrollable external factors. When the budget is met, planning, budgeting, and operations are congruent, that is, output, costs, and revenues correspond with projections. When operations are over- or underbudget, it signals the need for examination and feedback to the planning and budgeting processes. The problem may be ineffective management; that is, it was possible to achieve the tasks set forth in the budget with the amount budgeted, but resources were poorly used, resulting in cost overruns. When resources are poorly used, managers should examine why this is occurring. Does the manager have the skill and/or desire to control the resources he or she is entrusted with? A manager who has neither the skill nor the desire to steward the resources at his or her command should be replaced. However, competent and diligent managers also overrun their budgets. The question is, did the manager have access to timely and accurate information and the authority to alter resource use? When an organization's accounting systems do not provide detailed information on resources used and outputs produced, efficiency should not be expected.

Regardless of the efforts of managers, when planned programs cannot be achieved with the budgeted resources because of errors in the planning and estimation processes, operating managers should not be held responsible for the overruns. Managers finding themselves with insufficient resources are not without blame, as they should have made the underfunding clear during the expense estimation process. Underfunding of expenses could be due to unrealistic and overenthusiastic programming—the failure of senior management to recognize limits or the failure of budgeting to accurately determine resource needs and/or demonstrate to planners the financial impossibility of the scope of programs envisioned. Managers lose faith in a budgeting process that provides too little resources for the tasks required, despite the fact that the allocations may still bind them.

The integrity of the budgeting process also suffers when too many resources are budgeted and little managerial effort is required to meet targets. When costs are underbudget, planners and expense estimators need to know why: was it the result of a one-time saving, or is it an ongoing situation? When it is a recurring situation, planners need to identify where excess resources can be extracted and reallocated to increase the value of the organization. Budget personnel should also recognize why too many resources were allocated and how overestimation of resources requirements can be avoided in the future.

Upward feedback from operations to the planning and estimation processes is as essential to the budgeting process as the downward communication of goals and programs. Managers who use resources ineffectively and inefficiently need to be identified and trained. When the planning and financial feasibility processes systematically under- or overestimate resources requirements, this also needs to be identified and corrected. Regardless of where the problem lies, the budgeting process should provide the means to identify, inform, and correct prior inadequacies in planning, estimation, and management processes. The budget should serve as the basis for demonstrating to senior management the inability to carry forth programs, given available resources, and indicating to operating managers where costs are excessive. Effective budgeting requires four actions: (1) planners must produce a set of achievable programs, (2) operating managers must accurately determine costs of this set of programs, (3) budgeting must determine whether sufficient revenues are available to cover expected costs, and (4) all should be responsible for seeing that operations are effectively and efficiently carried out. Planners, operating managers, and finance share the responsibility for building a realizable budget to link programs to operations and fulfill the organization's mission and goals.

Evaluation

Guiding and assessing operations is the primary purpose of budgeting; it is where the "rubber hits the road." Variance reports are the tool managers should use to identify the way resources are being used, problems as they arise, and required remedial actions. Monthly variance reports should allow managers to modify their operations *before* cost variances grow to a size that jeopardizes organizational plans and/or are recognized by senior management. Retrospective, year-end evaluation enhances day-to-day management when it produces a greater understanding of the production process and the factors driving budget variances. Evaluation is the final phase of budgeting undertaken *after* the budget year is completed.

Retrospective, annual reviews may seem an unnecessary task, since monthly variance reports have been provided, resources have been expended, and history cannot be altered. This view fails to recognize that evaluation has a different objective than facilitation and control. Evaluation is a means to judge management performance and reward managers who met goals and institute remedial action for those who did not reach their objectives. Retrospective evaluation provides an opportunity to understand longer-term phenomena and improve future performance in a way month-to-month reports do not.

Managing performance using monthly variance reports is designed for rapid adjustment of operations during the budget year; year-end reports assess the managers' performance. Monthly variance reports are subject to month-to-month deviations; it is typical to see deviations from the budget on a period-to-period basis due to unforeseen events that make accomplishing tasks more (or less) difficult. Timing differences are also common, as expenses budgeted in 1 month may be paid in different months, creating a temporary surplus (if paid later than expected) or a deficit (if paid earlier than anticipated) during the budget year. Over a year, month-to-month positive and negative variations should offset, and thus the retrospective, annual assessment should provide a valid indicator of manager performance.

How should a manager's performance be evaluated if he or she meets the budget 1 out of 12 months or 8 out of 12 months? Obviously, this is a silly question, and month-to-month performance can be manipulated. What we want to know is, how did the manager perform over the entire year? Are total expenses less than the budget, and did the manager take effective action based on the monthly variance reports? Being underbudget for more months than overbudget may provide little insight into the effectiveness of managers. Assume manager A's actual expenses exceed the budget by \$500 over 11 months, and in the 12th month, the department is underbudget by \$8000. Then, for the year, manager A would be underbudget by \$2500 ($-$5500 (11 $*$ $-$500) overbudget + \$8000 underbudget). This performance is obviously superior to a manager who came in underbudget by \$500 eight times and was overbudget by \$1500 in the other 4 months, resulting in being \$2000 overbudget for the year (\$4000 (8 $*$ \$500) underbudget $-$ \$6000 (4 $*$ $-$1500) overbudget). All other things remaining constant, managers who come in underbudget for the year perform better than managers who are underbudget for more months than overbudget but are overbudget for the year.

Budgeting should provide an intelligent guess of what the future will bring, but with any prediction, it is likely that unforeseen events will produce an environment where projections are unachievable. Effective management in the face of positive and negative events uses monthly variance reports to alter operations to achieve the best-possible outcome. Poor management clings to the budget, as one clings to a life preserver after a ship sinks, and does not change operations despite environmental changes. The evaluation stage asks not only how the managers met their budgets but also how they performed when events did not match assumptions. Did the managers identify changes and appropriately alter resource consumption when output increased or decreased? The monthly variance reports provide the information necessary to facilitate operational change, given environmental changes. The year-end reports establish accountability and evaluate the managers' ability to adapt their operations when unforeseen events arise.

If actual expenses are consistently above the budget, it may indicate the assumptions used in the planning and cost estimation processes were unrealistic and nonachievable. If actual expenses are consistently lower than the budget, it may indicate planning is underestimating what the organization could achieve. Consistent surpluses (or year-end spend-downs) demonstrate that the budget underestimated the amount of output that could be produced, overestimated the cost of resources needed, or both. When costs are consistently lower than the budget, the goal should be to reallocate unneeded resources to other areas that can produce outputs of greater value to customers and the organization. The problem, as we will see, is that most managers spend unused funds on items of little or no value to prevent "their" resources from being reallocated.

The budget office is responsible for providing year-end reports comparing actual expenses to budget expenses that can be used to evaluate the managers' performance. Was the budget met? Were output volumes, input and output prices, and production processes different from those anticipated in the budget? If foreseen, would these changes have increased or decreased expected resource utilization? What factors caused these changes? Were these factors within the manager's control? Did the manager adapt to these changes and use resources wisely? Individuals who understand the budgeting process and participate in the prospective and concurrent phases should be able to move away from the simple question of whether the budget was met to a more complex understanding of what should have taken place. Budgets are built on estimates of what could happen; the evaluation phase should provide the information necessary to draw conclusions of what would have occurred if the future could have been perfectly predicted.

Use of year-end reports should not be limited to evaluating managers but should also assess the planning and estimation processes. How accurate were output and price projections? Were the projections significantly different from expected, and if so, why? To improve the planning and estimation processes, managers should take a multiyear view of operations and develop year-to-year comparisons to calculate growth rates in outputs, resource use, revenues, and costs and assess the accuracy of prior budget estimates. Is there a historic bias toward over- or understatement of these variables? If so, can this information be used to improve the accuracy of future forecasts? If forecasts can be improved, managers can rely more on planning for what will occur than reacting to budget variances. Information learned in the evaluation stage should be conveyed back to operating managers, the budget office, and planners to improve the efficacy of management, budgeting, and planning processes.

Systems and Budgets

Every production process can be better understood through the lens of system theory. A **system** is a set of inputs and procedures for accomplishing a task or achieving a goal. All systems comprise four parts with a feedback mechanism; **FIGURE 1.4** presents a generic system. A system starts with inputs that are assembled and transformed into outputs to fulfill some human need or desire. There are three primary inputs: humans, buildings and equipment, and raw materials (i.e., labor, capital, and land). Entrepreneurship or management is frequently cited as a fourth input. Inputs come in different grades and capabilities. Inputs are easy to see and control as they are generally tangible. The job of a budget is to identify the types of inputs required, balance the cost of inputs against their capabilities, and determine how much of each input is required to produce a given level of output.

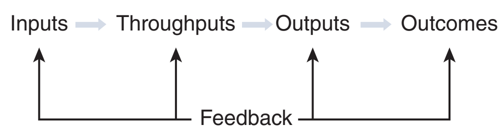

FIGURE 1.4 A Generic System

The second stage of a system transforms inputs into outputs. The throughput process encompasses everything required to coordinate the production process—policies, procedures, management, algorithms, recipes, etc. Throughputs are often intangible and difficult to conceptualize. Some throughput processes are “black boxes,” as it is easy to see the inputs going into a black box and the outputs that emerge, but there remains some mystery as to what happens to transform the inputs to outputs. Management is a black box, what exactly is management? Management involves motivating others to accomplish tasks, but what motivates people? Motivational techniques vary by manager, and a manager may employ different techniques on different employees in different situations or the same employees in different situations. What happens within a black-box system is often nondeterministic, meaning neither performance nor output can be predicted with certainty.

In some industries, like automobile production, the throughput process is a “white box,” that is, the amount and type of inputs are known and the production steps are well established. In white-box systems, it is easy to determine when excessive resource use occurs or when steps are missed, duplicated, performed poorly, or done out of sequence. In white-box systems, throughputs are easy to manage; in black-box systems, control often focuses on inputs or outputs as they are more easily quantified.

In most systems, it is easy to determine when the production process is completed and an output is produced. Products can be counted as they come off the assembly line and services when the interaction with the consumer ends (a physician visit begins when the patient appears at the office and ends when the patient leaves). Outputs are generally measurable: one sees the number of patients seen, students graduated, or widgets produced. It is natural to evaluate the input and throughput processes at this point since outputs are easy to count and evaluate. Complications arise with nontangible services, or services whose quality is difficult to define and measure. Effective control over the production process requires an output measure that captures the amount and quality of work performed and is accepted as valid by employees.

The effectiveness and efficiency of inputs, throughput processes, and outputs may be for naught if the organization is not producing a good or service that meets a real or perceived need. The essential measure of success for any organization is how well it meets a human need or desire, that is, what outcome is produced. Outcomes, like throughputs, are more difficult to measure than inputs or outputs. Outcomes for goods and services transacted in markets can be assessed by the ability to sell outputs at a price above cost. In voluntary market transactions, managers can ask whether customers were willing to pay the full cost of a product or whether customers believed the product was worth at least as much as they had to pay for it.

In health care, the number of patients seen or tests run is known, but do we know whether patients are better off? Did the health status or quality of life improve because of the care rendered? A better measure of healthcare success would determine whether patients were satisfied with the care they received and whether they perceived their life as better 1 year after receiving care. Ernest Codman recommended this standard in 1914, yet health care continues to evaluate patient satisfaction at the point of service (Codman, 1914). The ability to measure outcomes accurately and at the appropriate time is essential to enable managers to modify inputs, throughputs, or outputs to increase customer satisfaction.

Feedback loops are designed to keep systems coordinated and allow employees to improve outputs and outcomes by identifying problems and concerns so that corrections or enhancements can be made as early as possible in the production process. If the output does not produce the desired outcome, the feedback loop should focus the search for problems: Is the problem at the point of output (the wrong good or service is being produced), in the throughput process (production errors or problems are reducing the value of the output produced), or with inputs (improper or inadequate inputs are being employed, making it impossible to deliver a good product)?

The goal is to identify problems before substandard goods and services disappoint customers. Information on system performance should allow managers to pinpoint whether it is a problem with inputs, throughputs, or outputs that results in poor outcomes, customer dissatisfaction, low revenue, and/or high costs. Higher-than-expected usage of labor hours, supplies, machine time, etc., may indicate that substandard inputs are hampering the transformation process or the transformation process is operating suboptimally. Examining defective or deficient outputs allows employees to identify substandard performance, but discovery at this point does not allow corrective action before the production process is complete. Effective inspection of outputs can prevent the unknowing sale or delivery of substandard products to customers but requires duplicate efforts to correct defects. Properly constructed and used budgets allow managers to compare actual operating results with the expected standards and make timely system changes. As more information is typically better than less and as information is more valuable when received early in a process, managers should strive for prevention rather than detection of defects.

Management should facilitate production processes by ensuring the availability of inputs, the efficiency of the transformation process, and the quality of outputs and by ensuring that the output fulfills some need or desire. Feedback is essential to determine when system performance is substandard, identify the source of deficiency, and move the process to a level of performance that satisfies customers.

Three budget functions were identified: the first prospectively determines what it should cost to produce the types and quantity of goods and services set out by planning and whether the organization can generate sufficient revenue to purchase the resources necessary to produce the expected output. The operating plan, the approved budget, includes a set of inputs, production procedures, and total cost and establishes standards against which operations should be measured. The second, concurrent function of the budget facilitates day-to-day control over operations by providing information on actual performance and standards: is the process operating as expected? This question deals with the quantities and costs of inputs used, the outputs produced, and the outcomes achieved and should provide timely information to managers so that corrective action can be taken before resources are squandered. The last function is retrospective evaluation undertaken with a full year of data so that temporary fluctuations are minimized and performance can be fairly assessed. Were organizational goals achieved? Who, if anyone, is responsible for positive and negative deviations from the budget? What incentives are in place to tie organizational and employee goals together? System theory allows managers to move beyond analysis (what is happening) to synthesis (how thing work together toward a common goal).

Budgeting Systems

The primary focus of a budgeting system is typically on one point of a system or production process (**FIGURE 1.5**). Incremental budgeting (Chapter 6) focuses on the use of inputs. A major reason incremental budgets are used is that inputs are easy to measure and building a budget does not require comprehensive insight into production processes. The goal of incremental budgeting is to prevent the waste of inputs, or, more accurately, to ensure no more resources are used than budgeted. The job of a manager is to ensure all inputs purchased are employed in producing a good or service, that is, employees are working their scheduled hours, supplies have not been wasted or diverted to other uses, etc.

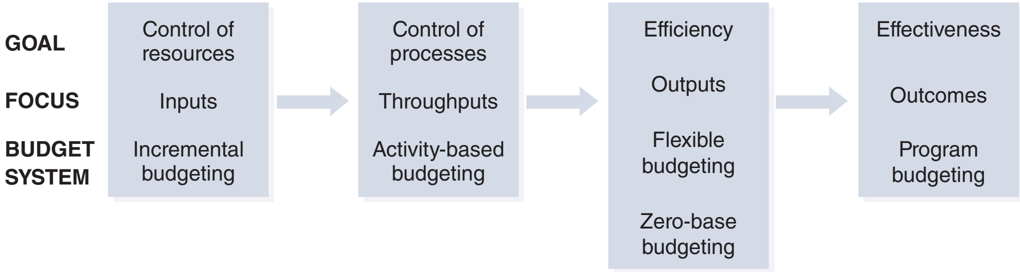

FIGURE 1.5 Budgeting Systems

The problem with incremental budgeting is that although employees may be at their appointed positions and resources may not be diverted, they may not be employed efficiently or effectively in the production process. The goal of flexible budgeting (Chapter 7) and zero-base budgeting (Chapter 8) is to ensure resources are used efficiently: not only should resources be in place, but no more should be employed than are necessary. This requires a greater understanding of the production process and the relationships between inputs and outputs. How many labor hours are required per output produced to ensure high-quality output? Flexible and zero-base budgets establish incentives for operating managers to minimize the cost per output produced.

Producing an output at the lowest-possible cost does not guarantee that anyone will want the output, so program budgeting (Chapter 9) shifts to a focus on outcomes. Program budgets are built around desired outcomes and attempt to quantify the impact of outputs on customers. Are customers satisfied, did they obtain the benefit they sought or expected, and will they continue to patronize the organization? Under program budgeting, managers are encouraged to maximize outcomes, including producing at the lowest-possible cost and possibly employing more resources when more or better outcomes can be produced at a low cost.

Activity-based budgeting (Chapter 10) adds realism to the budgeting process by recognizing that not all activities are created equal. A focus on outputs or outcomes ignores how they are produced, and activity-based budgeting identifies what employees do and for whom. In a hospital, the cost of providing inpatient care varies by patient, provider, and/or payer. For example, elderly patients may require a broader range of services, more services, and additional time to complete common services. Activity-based budgets recognize that changes in customers (the ratio of elderly to nonelderly patients) may have a profound effect on resource use, even if the number of admissions or patient days does not change. Activity-based budgeting focuses on throughputs and provides a basis for more effective management of resources and a differential pricing system that recognizes process and cost differences between customers.

The search for an effective way to monitor the totality of an organization's operations led to the development of **balanced scorecards** (Kaplan & Norton, 2000). Budgeting systems focus on one part of a system (inputs, throughputs, outputs, or outcomes) and the relationship between revenues and cost, whereas balanced scorecards examine the organization from four perspectives: financial, customer, internal or process, and learning and growth (**FIGURE 1.6**).

Balanced scorecards assess an organization's ability to pursue its goals. A balanced scorecard is a pyramid, with the pinnacle, or goal, of earning sufficient profits (or maximizing the value of the organization) to allow the organization to survive and thrive. The profit perspective asks the overarching question, is

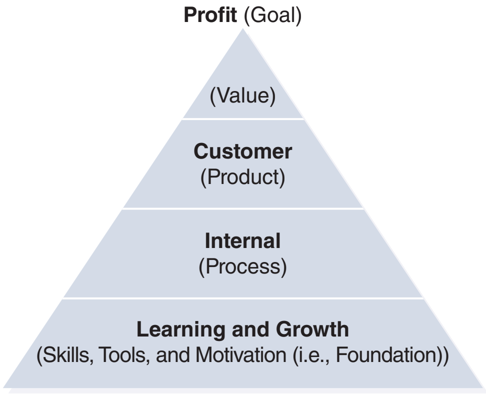

FIGURE 1.6 The Balanced Scorecard Pyramid

the organization meeting its goal? Are revenues greater than expenses, and is value being created? Sustained profit requires satisfied customers, so balanced scorecards identify, monitor, and encourage things that customers value (level 2). Measures of how well the organization delivers products that satisfy customers include satisfaction surveys, an expanding customer base (an increase in the number of customers), an increase in the percentage of repeat customers (do past customers return?), and a larger market share.

The profit and customer perspectives rest upon internal processes (level 3), or how the organization delivers products that satisfy customers. Customers seek effective and efficient internal processes, as evidenced by low prices based on cost minimization, timeliness, and high reliability. The learning and growth perspective (level 4) recognizes that the world is continually in a state of flux and organizations have to adapt to change or be left behind. Although profits and customer satisfaction may be high today, this does not guarantee future success. Changing consumer tastes and preferences, new technology, and the emergence of new competitors and products sink organizations that fail to recognize and respond to changes. The learning and growth perspective asks what an organization needs to ensure effective and efficient processes. Changing consumer preferences and technology require organizations to have the ability to anticipate and react to change; develop capable employees through training, education, and high performance standards; and provide workers with the right tools (information, equipment, etc.) to maximize their performance.

Balanced scorecards identify the major areas that determine an organization's success, but at this point, they do not tie these factors to resource allocation. Most budgeting systems do not take the comprehensive view that balanced scorecards pursue, although activity-based budgeting comes closest to a holistic understanding of how organizations operate, while program budgeting emphasizes outcomes received by customers. A balanced scorecard is not a substitute for budgeting, but it is clear that its emphases (the cost of satisfying customers, effective and efficient processes, and learning) can improve planning, management, and budgeting.

Evaluating Performance

The existence of for-profit organizations is based on their ability to generate adequate returns for their owners. Suppliers of inputs continually evaluate how their resources are employed, and economists utilize the concept of **opportunity cost**, the alternative foregone, to analyze resource allocation choices. This concept is helpful in understanding how individuals and organizations should approach budgeting decisions.

A mom-and-pop operation may choose to close its doors if the monetary return the business produces is less than what it can earn by employing their labor and capital in another type of business or working for someone else. As long as mom and pop earn more for the time and resources they invest in their business than they could earn by working for Google (or another employer) and putting their nonlabor resources into income-earning assets, they continue their business. At the point where they can earn more by working for Google, say, and lending their capital to others, they may alter the employment of their resources. Of course, there are intrinsic benefits from running your own business, and being your own boss can outweigh marginal income differences.

Large, publicly held corporations face the same constraints: do operating profits keep stockholders and lenders satisfied? If stockholders foresee that earnings may not be equal to comparable investments, they sell their stock (driving down its price) and reinvest in other companies (driving up the price of their stock). The continual re-evaluation and repricing of investments in equity markets produce comparable returns for comparable risks, and the only way to earn higher income is to invest in riskier ventures. Managers face the same trade-off when constructing budgets: which programs and processes add the most value to the organization, which should be funded, and how much funding should each receive?

Value matters. This is the bottom line of budgeting: what is the relationship between the benefits and cost of production? Are the benefits of production sufficient to justify the resources employed? In for-profit organizations, this rule can be reduced to whether the organization is earning an adequate profit for the risk assumed. If returns are inadequate, for-profits have two options: they can increase revenues and/or decrease expenses to improve operating results or go out of business. Organizations with inadequate returns on the resources employed who do not take effective action will see their resources involuntarily redeployed to uses that are more profitable. The marvel of markets is they operate automatically: well-managed organizations are rewarded with higher stock prices and lower interest rates, while poorly managed operations see stock prices decline and interest rates increase. The efficient allocation of resources does not require an expert or czar but functions because individuals desire the highest return for their resources and maximize their well-being by moving resources from low-yield to high-yield investments.

Profits are a simple means to understand the value of an organization and where resources should be increased and reduced. Resource decisions are less clear in nonprofits and public organizations, where profit signals are absent. The goal of maximizing value remains, but how does one measure the value of nonmarket transacted goods and services produced by nonprofit and public organizations? Overlooking this measurement issue, if a nonprofit is ineffective, inefficient, or both, it is in jeopardy of losing its customers to other organizations that can produce a higher-quality good or service at a lower price. Ineffective and/or inefficient nonprofits will have difficulty raising capital through donations or debt markets. Nonprofits cannot raise capital through equity markets and are regulated by the same mechanism as for-profits in debt markets. Lenders will analyze nonprofit operations to determine whether debt is likely to be repaid, and nonprofits that cannot cover their expenses will be unlikely to get loans. Similarly, philanthropists wanting to achieve a certain goal, for example, maximizing health or knowledge, will seek medical or education institutions that they think are best able to meet their desired outcome. Institutions that waste resources, that is, produce a small amount of goods and services for the resources employed, will see their donations redirected to more effective and efficient institutions.

The exception to this rule is public agencies. Government agencies do not have to operate effectively or efficiently, since they rely on public financing. Their revenues do not come from voluntary transactions with customers, investors, lenders, or philanthropists but from compulsory taxes, and inefficient performance is more likely to produce higher taxes than discontinuation of operations. Ineffective or non client-satisfying performance is also unlikely to lead to agency failure. The ballot box regulates public operations, but it is questionable how effective this mechanism is in minimizing production costs or maximizing client services. The main problem is that the interests of the two primary beneficiaries of free or subsidized government services, clients receiving the goods and services and public employees paid to produce the outputs, have an interest in continuing or expanding programs regardless of performance, since they receive large benefits and provide little, if any, of the resources required to fund operations.

The Benefits of Budgeting

A well-structured and well-understood budget provides multiple benefits for its customers, owners, and employees. First, the budgeting process is a means to educate employees on how the organization operates. The process of allocating resources, managing to a budget, and evaluating year-end results should provide employees with a greater understanding of the organization's sources of revenue, inputs and input costs, operations, outputs, and outcomes (**BOX 1.1**).

The second benefit is securing the involvement and buy-in of employees. The involvement of operating managers is crucial to the construction of realistic budgets, as they have the best understanding of their operations. Their involvement provides an opportunity to educate senior management and finance on their departments' processes. Senior management and finance operate at the organizational rather than the departmental level, focus on different matters, and often have a minimal understanding of operating department processes. This knowledge problem is often more severe in large and diversified organizations. The involvement of operating managers in the budgeting process is essential for cultivating their attachment to the plan and maximizing the usefulness of the budget.

Third, the budget is a means to communicate the organization's priorities to internal and external constituencies. The budget shows what the organization intends to accomplish, and budget allocations demonstrate management's commitment to goals. Managers committed to building a customer-friendly organization will devote resources and have a plan to cultivate and monitor the behaviors required to meet such a goal. A $4 million allocation toward achieving a goal demonstrates greater commitment to the activity than a budget of $1 million. An organization's mission statement may emphasize increasing employee wellness, but if the budget allocates only $500,000 to wellness programs out of a total budget of $100 million, one-half of 1%, is it really a priority? Budget allocations demonstrate management's commitment in dollars and provide the means by which the organization expects to achieve its goals.

The budget demonstrates what is important to managers and where they will focus their attention and efforts. The selection of a budgeting system tells employees what is going to be measured (i.e., inputs, outputs, outcomes, or activities) and how it will be measured, and may establish the metrics for employee performance evaluation. Incremental budgets create cost awareness, flexible and zero-base budgets emphasize productivity, program budgets focus on outcomes, and activity-based

BOX 1.1 The Benefits of Budgeting

- Educating employees on how the organization works
- Securing the employees' buy-in through their participation in budget construction
- Communicating organizational goals and priorities
- Establishing performance measures (what is important, and what will be monitored)
- Elevating the organizational view above department perspectives
- Establishing an operational plan
- Setting a standard for evaluation

budgets aim at controlling work processes. What is measured gets attention, and the budgeting system chosen can increase or reduce accountability. Accountability is essential to achieving the objectives of the organization and is diminished or lost when focus is placed on less relevant but more easily measured factors. Healthcare organizations should target improving health (an outcome) rather than increasing the number of admissions, patient days, surgeries, or office visits (outputs), while educational organizations should focus on increasing the knowledge and skills of students rather than graduation rates.

The master budget highlights the need to cover costs; unfortunately, managers in non-revenue-generating departments often do not see the necessity of balancing revenues and expenses and develop an incomplete and naive view of the organization and its constraints. Without profit, or excess revenue over expenses, organizations do not survive. The saying "no margin, no mission" neatly encapsulates this thought; organizations that cannot cover their expenses will be unable to serve their customers or clients, owners, or employees over the long run.

Budgets should make employees and others aware of the necessity of producing adequate returns on investment that allow capital to be replaced as it wears out. Revenues equal to expenses is not a sustainable position. Assume a building was constructed in 1988 and needs to be replaced in 2018. Its replacement cost will be substantially higher than its original construction cost because of an increase in the price of raw materials and wages, as well as more stringent building codes. Budgets should raise employee awareness of the constraints and trade-offs facing the organization. When an organization chooses to operate programs at a loss, the budget should indicate where funds will come from to pay the unmet expenses and replace capital. Understanding the totality of an organization's economic situation should encourage employees to take actions consistent with its long-term survival and emphasize the tie between their individual interests and behavior and the well-being of the organization.

The budget is an operational plan that plans, guides, sets expectations, minimizes surprises, avoids shortages and excesses, and moves the organization toward its desired future. Employees should continuously evaluate performance using variance reports to make timely alterations to input use, production processes, and output to meet internal standards and external demands.

Lastly, the budget provides the standard for evaluating performance: was the plan followed? Against this standard, managers should be able to identify what went according to plan, better than expected, and worse than expected. When better- or worse-than-expected results arise, managers should identify the causes of favorable and unfavorable changes to continue the former and avoid the later, when possible. Budgeting is a tool for establishing expectations and interpreting actual performance, improving future performance, and evaluating and compensating employees.

The introduction to financial planning and management began by describing the problems impeding the effective development and use of budgets, and it concludes with the advantages that accrue to organizations that fully utilize budgets. Budgeting is often reviled within organizations as a waste of time, if not counterproductive; this is not due to any lack of usefulness of budgeting but rather to the poor way budgets are used. Organizational life is simplified, and conflict reduced when employees understand the goals, processes, and reward mechanisms in budgets. When employees understand the purpose of a budget and utilize the benefits it provides, they may stop seeing budgeting as another bureaucratic task to endure and may instead see it as a tool to elevate their understanding and performance.

Summary

Budgeting comes in threes. There are three primary parties: senior management, operating managers, and finance. There are three budget functions: estimation of budget year revenues and expenses, facilitation and control, and evaluation. These functions occur in three distinct time periods: before, during, and after the budget year. Budgeting pursues three goals: controlling resources, ensuring efficiency, and guaranteeing effectiveness. Senior management and the budget office should ensure that employees with little or no financial training understand the goals of budgeting and serve as resources for managers to improve their ability to plan, manage, and evaluate operations. Finance professionals should strive to elevate nonfinancial managers' understanding of the budgeting process rather than simply providing them with the minimal tools needed to construct a budget.

The prospective role of budgeting translates senior management's goals into monetary terms and determines whether the organization has the resources needed to complete the work it has set for itself. Once achievable plans are established and approved, the budget should be used throughout the budget year to determine whether the plan is being met. Are revenues and expenses on budget? When goals are not achieved, monthly variance reports should facilitate the discovery of what is preventing success and what corrective actions should be taken. After the close of the budget year, the budget should be the basis for understanding operating results, establishing accountability, and motivating employees. The incentives managers follow and the results organizations achieve are determined by the budgeting system used. Budgeting systems can be constructed around inputs used, outputs produced, results achieved, or activities performed. What the budget focuses on, measures, and rewards will largely determine where employees invest their efforts.

Performance matters regardless of the ownership status of the organization. Budgets fulfill the same functions in for-profits, nonprofits, and public organizations: they exist to maximize the value of the organization by establishing standards and accountability. Budgeting may be more important to public and nonprofit organizations than for-profits, given the lesser control market forces play in determining the survival of these organizations. Managers who fully understand the budgeting process should see their role not only from the perspective of their departments but also as an integral part in the achievement of the larger goals and future of the organization.

Budgets not only establish the financial, operational, and evaluation standards, but when shared, they also are potent communication tools. They educate customers, employees, and other members of the public on the organization's operations and priorities. Management's willingness to share financial information and ensure employee understanding of financial issues will benefit the organization by focusing the employees' attention and increasing their commitment to its goals. Budgets are an opportunity to unify organizations and launch them on a path toward success, but this vision cannot be realized if managers and employees do not understand their roles and the functions of budgeting.

The remainder of the text takes you on a tour of financial management so that you understand the functions of finance and produce budgets to achieve desired objectives. Managers should not only be technically knowledgeable about their operations but also understand how accounting, economics, finance, strategic behavior/game theory, and program analysis concepts and tools can improve the performance of their area of responsibility. The text is not about accounting and how to fill in forms; rather, it is about how to improve operations by understanding the focus, goals, processes, and strengths and weaknesses of budgeting systems.

Key concepts include planning, management, accountability, revenue-driven costs, incentives, information, efficiency, effectiveness, and choice. Management needs a budgeting system that will work with it instead of against it to obtain the desired behaviors and outcomes that will benefit management and the organization. Knowing which budgeting system to use is the goal of this text.

Key Terms and Concepts

Balanced scorecard
Budget
Effectiveness
Efficiency
Financial competence
Incremental budget
Master budget
Mission
Opportunity cost
Strategic decision-making
System
Tactical decision-making
Unity of command

Discussion Questions

1. What is a budget, what is the goal of a budget, and what are the three functions of budgeting?
2. Explain the chief criticisms of budgets.
3. What are the roles and responsibilities of senior management, finance, and operating managers?
4. Why do departments and organizations spend more than what was budgeted?
5. Define effectiveness and efficiency and describe the relationship between them.
6. Why is profit (or excess revenue over expenses) necessary?
7. What is the difference in budgeting for for-profit, nonprofit, and public organizations?
8. Explain the five components of a system.
9. What is the goal of system thinking?
10. What are the benefits of budgeting?

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