



# Budgeting - Overview

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1. Budgets as a mechanism of partitioning decision rights and as a mechanism for control.

- Decision management
- Decision control

2. Incentives

- Performance measurement
- Compensation
- Horizon problem
- Perverse Incentives

3. Types of budgets

- Line Item Budgets
- Lapsing Budget
- Flexible Budget
- Zero based budgets
- Incremental Budgets



# Budgeting

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Theoretically, budgets serve two roles:

## 1. Allocate Decision Rights:

- Decision Initiation – Budget Preparation
- Decision Implementation – Operating Decisions

## 2. Control Behavior

- Decision Ratification
- Decision Monitoring

Budgets are also used as a method of measuring performance, a mechanism to plan expenditures, and to reward performance.



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Let's make sure we know what budgets are from a practical perspective:

1. They are plans for 1 to 10 years for all of the business units.
2. The budgets serves as a mechanism for coordinating production and sales
3. Estimates are compared to actual as a means of evaluating performance.
4. Budget variances are often used as a means of punishing and rewarding behavior.
5. Budgets are updated to reflect outcomes.



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Firms often use budgets to measure the performance of managers.

When budgets are used to measure performance we need to think about the concepts of:

- Controllable Variances
- Uncontrollable Variances



## Rosebud (Prob 6-28)

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See the exercise “Old Rosebud Farms”: Problem 6-28 in  
**Zimmerman, Jerold L. *Accounting for Decision Making and  
Control (4<sup>th</sup> Edition)*. McGraw-Hill/Irwin, 2002, pp 316-7.**



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We also need to think about how do you account for volume effects?

What happens when there is a reduction in volume?

Does it matter if it is controllable?

- Static vs. Flexible Budgets.



## Golf World (prob 6-9)

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See the exercise “Golf World”: Problem 6-9 in Zimmerman, Jerold L. *Accounting for Decision Making and Control (4<sup>th</sup> Edition)*. McGraw-Hill/Irwin, 2002, pp 301-2.



## Budgeting -Textbook sales

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When budgets are used to measure performance, they are also often used in the compensation scheme.

Consider the following compensation scheme used in textbook sales.

The head office forecasts sales for each sales territory using the ratcheting principle.

The sales rep prepares a budget for complementary books and over night visits that is approved by the head office.

Sales reps are compensated a fixed salary and receive a fixed bonus for reaching their budgeted revenues

They receive a small fractional increase bonus money for each dollar of sales generated over the budgeted amount through 110% of the budget

Larger bonuses if budgeted revenues are exceeded by more than 10%.





## Budgeting -Textbook sales

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What are the sales rep's incentives?

What mechanisms does the sales rep have to influence actual outcomes

What do you think the sales pattern of a textbook rep looks like over time?

What incentives does the rep have if incentive pay is based on budgeted income instead of budgeted revenue?



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## Types of Budgets

1. Line item budgets
2. Lapsing Budget
3. Zero based budgets
4. Incremental Budgets



## Budgeting

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What is a line item budget?

How are decision rights allocated in line item budgets?

How does a line item budget control behavior?

What incentives do line item budgets provide?



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What is a lapsing budget?

How are decision rights allocated in lapsing budgets?

How does a lapsing budget control behavior?

What incentives do lapsing budgets provide?



# Budgeting

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What is a zero based budget?

How are decision rights allocated in zero based budgets?

How does a zero based budget control behavior?

What incentives do zero based budgets provide?



# Budgeting

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What is an incremental budget?

How are decision rights allocated in incremental budgets?

How does an incremental budget control behavior?

What incentives do incremental budgets provide?



# Budgets - Summary

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Budgets are an important mechanism in the allocation of decision rights.

Budgets are often used to measure performance

Budgets are also used as a mechanism for control.

There is a tradeoff between decision control and decision management

Identify the strengths and weaknesses of various types of budgets.