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MANAGEMENT ADVISORY SERVICES FORUM

Gentlemen:

In quantitative terms how accurate should management expect a budget to be? How does it go about setting parameters of accuracy which it can then use to evaluate the effectiveness of a budgeting group?

Do you know of any literature which addresses itself to this problem? Frankly, we have had little success in routine requests to libraries of associations and universities.

Your help would be very much appreciated. If there really is the dearth of material that there appears to be, your comments on why this is so would be valued.

Two members of the MAS Forum panel replied to this question. Here is the first reply, received from a large Eastern firm:

The question appears to be a loaded one, betraying feelings of having been treated unfairly. There may also be overtones of defensiveness. In such a case, no answer is likely to improve matters, or even to afford satisfaction.

First, let it be said that there is no single standard of accuracy, because varying potentials for accuracy inhere in specific items within a budget. Certainly the techniques for arriving at forecasts of sales are less precise than the methods for calculating estimates of cost. Furthermore, the input data are likely to be less reliable for sales forecasts than for cost estimates.

A budget group's responsibility for sales forecasts lies in using the most appropriate techniques available and the most reliable information. They can match their total sales forecast with macroeconomic projections of gross national product and their product line forecasts with industry estimates from Input/Output charts. For individual products, they can extrapolate trends and generate internal data on product life cycles. They can also take into their calculations customer inventory levels, advertising

PANEL OF ADVISORS:

Under the auspices of MANAGEMENT ADVISER, a panel of management services advisers from leading accounting firms have agreed to answer to the best of their ability questions about any area of management advisory services with which readers would like help. Both questioners and advisers will remain anonymous. One or more of the following members of our panel are responsible for the answers published in this department:

WILLIAM E. ARNSTEIN, *Main Lafrentz & Co., New York*
PHILIP L. BLUMENTHAL, *Geo. S. Olive & Co., Indianapolis, Ind.*
ROY A. LINDBERG, *J. H. Cohn & Company, Newark, N. J.*
ARTHUR B. TOAN, JR., *Price Waterhouse & Co., New York*
H. G. TRENTIN, *Arthur Andersen & Co., New York*
ALLEN WEISS, *Laventhol Krekstein Horwath & Horwath, New York*

and promotion plans, and segmented market data.

Having done all these things, a budget group must face the occupational hazards of prognosticators with heads held high and fingers crossed. Courage is a requisite of the job, even though others are consulted and agreement is sought, whether the Delphi technique is employed for this purpose or some less formal method.

Even with the best of techniques, some items defy prediction. A new product that is radically different from anything on the market presents special problems. And if competitors are in a race to bring similar products to market, the problems are accentuated. Besides, market studies, on which new product plans are based, are probably not conducted by the budget group. Hence, the budget group's responsibility for new product forecasts is ordinarily limited.

Degrees of precision

Whereas sales forecasting is subject to large errors of prediction, expense estimating can be made much more precise. Flexible budgeting, based on analysis of expenses into fixed and variable components, takes the sting out of departmental volume variances.

Still, rising prices and fluctuating prices can cause difficulties. Where price fluctuations can be severe, as for products made out of commodities, it may be better to budget gross margins instead of sales and cost of sales. Even less erratic price movements are not necessarily predictable by the budget group; accordingly, they are likely to get their estimates from the purchasing agent. In that case, the responsibility for price variances lies with him.

To discuss fully the subject of budget accuracy, we need to concern ourselves with the purposes of the budget. For some objectives require greater accuracy than others. We may take the purposes of a budget to be financial planning, coordination of operations, and control; and we may consider the requirements of each with respect to accuracy.

In financial planning, prediction is important, but tolerable levels of input error vary over a wide range, as sensitivity analysis studies have shown. It is a good idea to determine where the sensitive areas lie, so that concentrated efforts can be made to tighten up there.

In coordinating operations, volume ranges rather than specific figures are generally used for decisions concerning preparatory measures. Consequently, estimating precision is seldom critical in this aspect of budgeting.

When budgeting is used for control, variances caused by inefficiency among operating people are their responsibility, and the effort is directed toward improving their performance. If a budget is too tight, however, resentment may develop toward the budget group for treatment that is considered unduly harsh. It is the business of budget people to set reasonable standards of performance, standards that are neither too stringent nor too lax.

But variances are not always the fault of the operating groups. If the standards themselves are faulty (not merely tight or loose), then it is up to the budget group—with the assistance of the operating people, if that is possible—to work out better methods. They may find more reliable relationships on which to base their estimates, or better definitions of recognized relationships from which to calculate their parameters.

The use of information fed back from one budget cycle to improve the estimating methods of the next cycle is essential to sound budgeting. A budget group that neglected to gather feedback and make use of it would be derelict in the performance of its duties.

To summarize, there can be no single standard of accuracy that would apply to all parts of a budget; nor do the separate purposes of budgeting require a uniform standard of accuracy. The ingredients of good budgeting are: the best available information, the most appropriate techniques, sound judgment, and a little luck. For persistent problems, the remedy may be flexible budgeting and break-even analysis.

. . . and here is the second, which comes from a major firm with headquarters in New York:

Given an accurate sales forecast, an annual budget of costs can be quite accurate, say plus or minus 2 to 3 per cent. Individual accounts may be expected to show larger variances, but pluses tend to offset minuses, bringing the total within this range. This degree of accuracy is only possible if there are no major unanswered questions when the budget is prepared and no major changes in operation occur within the year. Larger variances are acceptable if budgets cover periods beyond one year.

The types of unanswered questions which tend to plague budgeters are:

Union contracts,

Raw material price trends,

New products,

New manufacturing or sales facilities, and

Pollution control.

Operation changes which may occur unexpectedly include strikes, fires, major machinery breakdowns, unsatisfactory product quality, and any changes in basic company policies.

In some instances, operating management will attempt to satisfy top management that it is adhering to its budget by cutting back on so-called "programed costs." These are costs such as advertising, research, and training which are discretionary in the short term and can be cut back almost immediately.

Needless to say, budgeted costs in manufacturing tend to be more accurate under a standard cost system which is itself closely controlled and in which the standards have been properly determined.

Many companies feel that the

forecast of sales is sufficiently subject to error that they produce a variable budget, i.e., a budget in which certain costs are budgeted as a percentage of sales. Although the annual budget will show a specific sales figure, comparisons with actual show variable costs as the budgeted percentage of actual sales. This method is perhaps the fairest way of judging operating management's ability to control costs.

All of this leaves unanswered the question of how accurate a sales forecast or budget is expected to be. Methods of preparing such forecasts, including analysis of economic trends, the company's growth pattern, expectations with regard to specific industries to which the company sells or even in relation to specific customers, have been the subject of many books and many articles. Grass roots projections and top-down projections are usually covered. However, the accuracy which may be expected is still dependent on the company's industry and its percentage share of the industry.

For example, a company selling bread to a chain of supermarkets can forecast more accurately than can a manufacturer of hula hoops. A company building naval vessels with long lead times can forecast more accurately than a company operating a jobbing machine shop in which each month's business is related to its success in bidding in the prior month. An Eastman Kodak can forecast quite accurately because its share of the market is so large that its sales will depend on economic conditions and its own sales trends whereas a company selling one-tenth of one percent of all monkey wrenches manufactured could easily triple its sales by acquiring one large new customer.

Possibly the foregoing is more nearly an answer to the last paragraph of your inquiry, wherein you ask why there is so little material indicating what range of accuracy is acceptable in budgeting. It also attempts to indicate the areas within a budget in which accuracy may be expected.

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