UNIVERSITY OF TOLEDO INTERNAL AUDIT DEPARTMENT
DEVELOP BUDGETS

Control practices

The following control objectives provide a basis for strengthening your control environment for the process of developing budgets. When you select an objective, you will access a list of the associated business risks and control practices. That information can serve as a checklist when you begin reviewing the strength of your current process controls.

This business risk and control information can help you assess your internal control environment and assist with the design and implementation of internal controls. Please note that this information is at the generic business process level and many companies will need to go beyond generic models to address the specific business processes that support the financial and nonfinancial disclosures being made. You can combine the insight of this business risk and control information with your industry-specific knowledge and understanding of your company's environment when conducting internal control assessments and designing and implementing recommendations.

Effectiveness and efficiency of operations

A. Activity-based budgeting and activity-based costing are used to link costs to key drivers.
B. Budgets are used to monitor performance.
C. Employee incentives are tied to performance measures other than meeting budget targets.
D. Budgets that accommodate contingency planning and changes in assumptions are developed.
E. Capital and operating budgets are linked and both are tied to the company's strategic plan.

Reliability of financial reporting

A. Reliable budgets and short-term plans are prepared.
B. Accurate and complete variance and trend analyses are generated.

Effectiveness and efficiency of operations

A. Activity-based budgeting and activity-based costing are used to link costs to key drivers.

Business risks

- Managers will not be able to evaluate product and service performance.
- Budgeting process will focus on costs rather than the drivers that cause costs to increase or decrease.
- Managers will focus attention on low-value activities.
- Managers will not be able to explain and correct budget variances.
- Meaningless overhead allocations will cause inaccurate budget forecasts and estimates.
- Distorted product costs will cause inefficient resource allocations.
- Budgets, performance measures, and cost behavior will not be linked.
- Managers will not be able to answer some of the critical questions that drive their success or failure: 1. what are our costs? 2. Where should we focus our attention to control costs? 3. What activities are driving our costs?

Control practices

1. Utilize process mapping to identify the full set of interrelated activities performed to produce products and services. (Process mapping is the systematic linking of line items in a traditional budget to a list of activities or processes. The result is a picture of how much a company spends on these activities and the resources used in accomplishing them.)
2. Allocate costs to activities using cost driver information appropriate to the activity.
3. Create flexible budgets based on activity costs. (Flexible budgets use input data rather than output data to provide more accurate analyses of volume, efficiency, and expenditure variances.)
4. Charge individual departments or business units for capital usage.
5. Charge overhead or corporate-controlled costs, such as telephones and IT, to the individual business units only if cost drivers are influenced at the business unit level.
6. Designate process owners to monitor those processes that cut across the entire company.

B. Budgets are used to monitor performance.

Business risks

- Performance targets will be padded if managers feel that budgets will be used to monitor their performance.
- Budget process will become a punitive rather than diagnostic approach to problem solving if budgets are used as control rather than monitoring tools.
- The likelihood that departments will shift blame or manipulate numbers rather than document and act to correct important variances will increase.
- Managers will not improve subsequent forecasts as they learn from experience.

Control practices

1. Assign specific business units and departments within them responsibility for tracking budget to actual variances and report variances to senior management when they rise above a predetermined threshold.
2. Identify cost drivers for each major budgeted area and use those drivers, rather than just the variances in budgets themselves, to monitor performance. For example, manage head count rather than payroll costs because head count drives payroll.
3. Prioritize variances between budget and actual results when presenting to management so that the lower-priority activities can be revised or eliminated.
4. Implement a "plan, do, check, act" process for budgeted items. (Budget, execute with the goal of staying on budget, analyze performance, and use the results to redirect activities.)
5. Conduct a post-project appraisal for capital budgeted projects to assess the project's purpose, link to strategy, actual versus projected cost, and actual versus projected performance, such as increased revenue or cost reduction.

C. Employee incentives are tied to performance measures other than meeting budget targets.

Business risks

- Managers rewarded for coming in under budget will play the games that help them and their departments come in under budget.
- Managers will submit unassertive, easy-to-meet targets rather than goals that challenge their people.
- Managers will not focus on value creation.
- Focus on meeting targets will encourage budget padding.
- Competitive pricing on internal services will decline.

Control practices

1. Hold employees responsible for controllable financial and nonfinancial performance measures only.
2. Provide managers with the decision-making authority needed to influence the measures against which they are evaluated.
3. Involve business units in selecting the performance indicators most appropriate to them.

D. Budgets that accommodate contingency planning and changes in assumptions are developed.

Business risks

- Managers will take a short-term planning perspective.
- Changes in market forces will not be evaluated in terms of their effects on the assumptions driving the budget.

Control practices

1. Earmark strategic reserves (money set aside at the business unit level to meet competitive opportunities or threats) for unplanned contingencies.
2. Require managers to consider project planning fewer than three scenarios "most likely, optimistic, and pessimistic."
3. Conduct sensitivity analysis to determine the effects of changes in key drivers when preparing budgets and making assumptions. (For example, consider the effect on the outcome if a competitor enters the marketplace.)
4. Conduct interim budget reviews to determine if changes based on market or operating issues, are necessary.

E. Capital and operating budgets are linked and both are tied to the company's strategic plan.

Business risks

- Annual budgets will be controversial because the budgeting and planning processes are not well integrated.
- Budget process will not serve as an effective resource allocation tool.
- Significant confusion and rework will result from developing the capital and operating budgets in isolation.
- Decision makers will focus on juggling the numbers rather than on creating economic value added.

Control practices

1. Prepare all budgets after the strategic plan has been completed.
2. Submit capital and operating budgets for review simultaneously and integrate in terms of goals and purpose.
3. Set capital and operating budget horizons for planning purposes. (For example, set a two to three year plan for projects with longer payback periods.)
4. Require managers to show how proposed projects correspond with the company's strategic plan.
5. Focus budget training on developing business plans so that budgeting can be a business planning tool.

Reliability of financial reporting

A. Reliable budgets and short-term plans are prepared.

Business risks

- Budgets will not serve as reliable tools for management to use in monitoring business performance.

Control practices

1. Utilize an internally consistent document to synthesize, evaluate, and summarize all relevant inputs in the preparation of management's short-term plans.
2. Communicate the assumptions used to drive the development of budgets to all participants in the process.
3. Minimize budget "padding" (being overly conservative) by setting realistic goals aligned with the company's strategies.
4. Train managers and employees involved in the budget preparation process in appropriate budgeting techniques and in complying with budgeting policies and procedures.
5. Monitor budgets periodically and adjust for changes in business conditions so they do not remain static once set.

B. Accurate and complete variance and trend analyses are generated.

Business risks

- Significant variations, trends, and unusual changes will remain unidentified and unexplained.
- Insufficient information exists to perform meaningful analyses.
- Erroneous information is used in analyses.
- Calculation errors are made in analyses.
- Necessary information is not received in time to perform meaningful analyses, limiting management's ability to respond to issues and opportunities.

Control practices

1. Identify the key accounts and line items in budgets and short-term plans requiring continual analysis.
2. Implement standard analysis formats that specify which information inputs are required to perform evaluation as well as which analytical procedures must be applied to that information.
3. Procure written criteria for identifying significant variations or trends or unusual changes.
4. Require documentation for all supporting criteria and assumptions in the analysis process.
5. Test the analysis used in budgeting periodically for reasonableness, consistency, and accuracy.
6. Write and communicate deadlines for preparing variance and trend analyses and generating necessary reports.
7. Compare actual results periodically to management-approved budgets.
8. Assign accountability and responsibility for correcting errors identified through the budgeting process.
9. Perform exception reporting for significant variations of actual performance from planned performance.
10. Track an analysis of financial trends, including key performance indicators (inventory turnover, sales, cost of sales, market share, expense levels, days outstanding, and capital expenditures), and report significant variations between budgeted and actual performance as exceptions.