CPA BEC - STUDY UNIT 16
Planning and Budgeting:
Core Concepts

A. **Strategic Management**

1. **Strategic management** has a long-term planning horizon. Thus, a strategic orientation is traditionally associated with senior management. However, this orientation should pervade the organization because it encourages farsightedness by all employees.
2. The strategic management process includes the following steps: A **grand strategy** is developed to describe how the organization's mission is to be achieved. It is based on a **situational analysis** that considers organizational strengths and weaknesses (a capability profile) and their interactions with environmental opportunities and threats (SWOT).

B. **Nature of Planning**

1. Planning is the determination of **what** is to be done, and of **how**, **when**, **where**, and **by whom** it is to be done. Plans serve to direct the activities that all organizational members must undertake and successfully perform to move the organization from where it is to where it wants to be (accomplishment of its objectives).
2. The determination of **organizational objectives** is the first step in planning. A **mission statement** is a formal, written document that defines the organization's purpose in society.

C. **Premises and Objectives**

1. **Premises** are underlying assumptions. **Objectives** should be established for the organization and each of its subunits in a **means-end hierarchy**.

D. **Management by Objectives (MBO)**

1. Management by objectives (MBO) is a behavioral, communications-oriented, responsibility approach to management and employee self direction. MBO is a comprehensive management approach and therefore is relevant to **planning and control**. **Steps necessary to implement an MBO program** include establishing objectives and action plans (the planning steps) and periodic review and final appraisal (the control steps). When the subordinate's objectives are at odds with upper-level objectives, a **coaching session** is necessary.

E. **Forecasting**

1. **Forecasts** are the basis for business plans, including budgets. In addition to intuition (informed judgment), many quantitative methods are useful in projecting the future from past experience. Examples of forecasts include sales projections, inventory demand, cash flow, and future capital needs.
2. **Correlation analysis** is used to measure the strength of the linear relationship between two or more variables. Correlation between two variables can be seen by plotting their values on a single graph to form a scatter diagram. If the points tend to form a straight line, correlation is high. If they form a random pattern, there is little correlation. Correlation measures only linear relationships. The **coefficient of correlation** measures the relative strength of the linear relationship.
3. **Regression (least squares) analysis** extends correlation to find an equation for the linear relationship among variables. The behavior of the dependent variable is explained in terms of one or more independent variables. The simple regression equation is $y = a + bx + e$.

4. **Time series** or **trend analysis** relies on past experience. Changes in the value of a variable (e.g., unit sales of a product) over time may have several possible components. **Exponential smoothing** is a technique used to level or smooth variations encountered in a forecast. This technique also adapts the forecast to changes as they occur.
5. **Learning curves** reflect the increased rate at which people perform tasks as they gain experience. The time required to perform a given task becomes progressively shorter, but this technique is applicable only to the early stages of production or of any new task. Ordinarily, the curve is expressed as a percentage of reduced time to complete a task for each doubling of cumulative production.

F. **Project Management**

1. **Project management** techniques are designed to aid the planning and control of large-scale projects having many interrelated activities.
2. **Gantt charts** or **bar charts** are simple to construct and use. To develop a Gantt chart, divide the project into logical subprojects called activities or tasks. Estimate the start and completion times for each activity. Prepare a bar chart showing each activity as a horizontal bar along a time scale.
3. **Program Evaluation and Review Technique (PERT)** was developed to aid managers in controlling large-scale, complex projects. PERT diagrams are free-form networks showing each activity as a line between events.
4. The **critical path method (CPM)** was developed independently of PERT and is widely used in the construction industry. CPM may be thought of as a subset of PERT. Like PERT, it is a network technique. Unlike PERT, it uses deterministic time and cost estimates. Its advantages include cost estimates plus the concept of “crash” efforts and costs.

G. Budgeting

1. A **budget (profit plan)** is a realistic plan for the future expressed in quantitative terms. Senior management can use a budget to plan for the future and communicate objectives to all levels of the organization, to motivate employees, to control organizational activities, and to evaluate performance. The **master budget** encompasses the organization’s operating and financial plans for a specified period (ordinarily a year). The **operating budget** is the part of the master budget that consists of the pro forma income statement and related budgets. Its emphasis is on obtaining and using resources. The **financial budget** is the part of the master budget that includes the cash budget, capital budget, pro forma balance sheet, and pro forma statement of cash flows. Its emphasis is on obtaining the funds needed to purchase operating assets. A **fixed budget** is based on only one level of sales or production. A **flexible** budget is a series of budgets prepared for many levels of activity.