

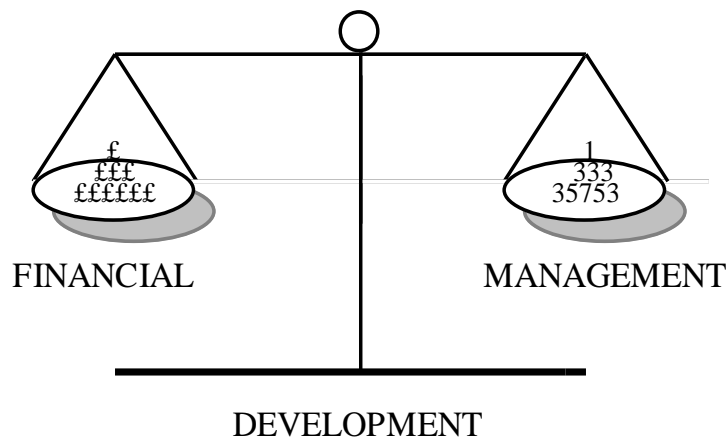
# FINANCIAL MANAGEMENT DEVELOPMENT

## Management Reporting

### Budgetary Control

NO 211

## BUDGETING



ONE OF A SERIES OF GUIDES FOR  
FINANCIAL MANAGEMENT DEVELOPMENT

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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

## BUDGETING

Budgeting is the conversion of planned activities into financial outcomes in order to help the planning and control of those activities. Every individual budgets in their personal life e.g. “If I spend my bus fare on an ice cream, I will have to walk home”. In business, budget setting is no different. It consists of the identification of what you want to do, a financial evaluation of the outcome, a review of whether the financial outcome is acceptable, consideration of associated risks and a decision on whether the original expectations need to be revised. Each of these activities will be considered in turn.

### 1. What do I want to do?

Every organisation has outputs. For most business entities these consist of goods and/or services which are provided to customers in return for cash. Ensuring that the cash to come in is “appropriate” when compared to the cash going out is an essential part of the budget process. Every part of the organisation has a role to play and it is this role which determines the outputs. The key functions can be split into:

1. Sales - Output is Sales Volume or Value
2. Production - Output is goods or services for sale
3. Administration - Output is the facilitation of 1 or 2.

In any organisation it is vital that the budget process starts with sales. Many organisations fail because they achieve their budget for production but fail to sell what they have produced.

For some departments the “sales” figure is unpredictable. In such cases the past is usually a good starting point – adjusted as appropriate for changes in:

- (a) The internal working practices e.g. we will target larger customers, we will increase marketing spend etc.
- and
- (b) The external environment e.g. our competitors have closed down, there has been a health scare over our product, there is a recession etc.

For production or administration departments not directly involved in sales the issues are the same but it may be easier to predict outcomes since the “customers” are more likely to inform you of their intentions. It may be in the organisation’s best interest to agree fixed volume contracts, estimates of demand or minimum and maximum volume. The pricing (or inter-group charging) strategy of the unit will need to be considered in order to convert the volumes into financial values. The consideration of impact of various pricing strategies on volume demand is an essential part of the Budget process. Some departments may not charge for their services - but unless chaos is to ensue some form of service level agreement should be included in the budget.

## 2. What do I need to do it?

### Staff

Probably the most common input is staff. The following questions may help the process of identifying the necessary budget:

### How Many?

How many staff have I got now?

How many staff will leave? (Use past statistics)

Will the volume change in output require more or less staff? (Use statistics from the past e.g. Sales per head, output per head).

Will changes in working practices affect the staff's efficiency? (Any planned expenditure on new machinery, computers or technology should be supported by a business case showing savings).

How many staff do I therefore need to recruit?

When will I recruit them? (Do not assume you can double staff numbers on the first day of the budget year. You will need to allow time for them to learn the job and for the existing staff to train them.)

### How Much?

The level of pay needs to be reviewed.

Will there be an across the board pay rise?

Will differential pay increases be made?

Are there any changes to the benefits package?

Once the staff numbers have been identified together with their rates of pay the budget can be calculated. Remember to include provision for all benefits – pensions, Employer's National Insurance etc. Remember to provide for redundancy costs if staff numbers are to be reduced.

NOTE: Budgeting is not a precise science, it is an art. The staff costs need to be predicted but excessive accuracy is not time well spent. In particular avoid too great a level of detail – total headcount times average pay will give a reasonable estimate. Use past statistics on illness and other leave to assess whether an additional budget is required for temporary cover/overtime to compensate.

### Materials

The budget for materials will often be directly influenced by the volume of sales. However, remember to allow for any time lag between receipt of raw materials and delivery of finished product. The budget should also allow for any planned changes in stock levels. Some organisations ignore stock and merely budget for the cost when purchased e.g. Stationery. It is important that the treatment is allowed for in the budget.

Wastage Levels

Many processes have yields which are less than 100% due to evaporation, edges being unutilised etc. The normal wastage level must be included in the budget .

Space

What will the impact of the volume changes be on space required for staff, storage, and production? Is the space currently available? What moving or reorganisation costs will be incurred?

Are there specific cut off points in the need for space e.g. we can cope with 12 people but for 13 we would need to move offices?

Is there a business case for any changes to the volume of space occupied (more or less)? Will the price paid for space (in total or per square metre) change?

Equipment

What equipment is currently used?

Will it need replacing – Is this a capital or a revenue budget item?

What will the impact of the volume changes be?

Is there a business case for investing in new technology?

Are estimates of useful lives and therefore depreciation costs correct?

### 3. **Is the Financial Consequence acceptable?**

Once the output volumes and appropriate prices have been estimated these can be compared with the estimated costs of the inputs.

Adequate Profit or Acceptable Loss

The value of the outputs less the value of the inputs identifies the value added (profit) or value destroyed (loss) from any unit. Unfortunately accounting often struggles with valuations – particularly of intangible assets. For many departments their value added is not easily quantified and they are treated as cost centres. Examples include:

Marketing

Human Resources

Research

Administration

Information Technology

And even Finance.

For the organisation as a whole it is essential that an adequate profit is made i.e. the return on capital employed in the business is acceptable to those who provided that capital.

The return need not be immediate e.g. Internet stocks in early 2000, but if a loss is to be made it must be acceptable.

For individual departments it is acceptable for a “loss” to be made i.e. for them to have net costs. However, as many outsourced department heads have discovered, unless the outputs are demonstrably more highly valued than the cost there is a danger that the business will take appropriate action.

In summary a decision is required on the acceptability of what must be viewed as the first iteration of the budget. This is sub-divided into various levels: Group, Division, Department, etc. and is interdependent e.g. the administration budget looks fine in isolation until the sales budget reveals a 50% reduction in income. This is why the budget setting process should always start with guidance on the growth expectations.

#### Cashflow

Commercial history is littered with the bones of companies which had acceptable profit budgets but failed to consider cashflow. It is vital that at the Group level the cashflow budget is reviewed. Cash is a resource. Business is about gaining a return on resources. Negative cashflow merely requires borrowing. Provided the interest can be covered by profit and the level of gearing (borrowings as a percentage of equity) is acceptable, an adverse cashflow is sustainable in the short term. The important factor is to ensure that the borrowing facility is forecast and confirmed before the need becomes apparent. Interest rates charged are often directly proportional to the need for funds.

#### Timing

Both the short and the long term consequences of the budget need to be considered. An acceptable year’s profit may hide an unacceptable first quarter loss. A cash surplus by the year end may be based on a forecast excess of the overdraft limit on every salary payment date. In practice this review should be done at Group level with profit timing reviewed on the basis of the external reporting cycle and the cashflow review limited to consideration of low points relative to available resources.

#### 4. What are the Risks?

Budgeting is based on assumptions. Some are relatively simple and safe and do not need to be stated. “This budget assumes that the world will not end during the budget period”, is rarely explicitly stated (although one day it will prove to be wrong). Others are both fundamental and inherently risky; “The budget assumes the Union accepts a 3% pay rise”. “The sales forecast is dependent upon recruitment of five new sales people”. “Material prices are expected to rise in line with RPI”.

For every budget the key assumptions should be stated together with an indication of the rationale for that assumption. The agreed budget must be the outcome that is considered most likely. It should, therefore, have a 50% probability of being too high and a 50% probability of being too low. Any other approach can cause problems – particularly if pessimism or optimism is excessive.

The stated assumptions should concentrate on the major incomes and costs and the factors which would influence them. This includes statements that there are no risks e.g. “The pay rise is fixed at 3% under a two year agreement made last year”. This aids review and pre-empts questions.

Every attempt should be made to consider how to mitigate risk. These include:

- Timing: “Capital expenditure will be budgeted for the second quarter but if sales forecasts are not achieved it will be delayed.”
- Fixing: “Take or pay contracts have been agreed with the three largest customers”.
- Hedging: “The exposure to the Euro has been capped through a forward agreement”.

## 5. Review?

Once all the above has been done it is vital that the budget be reviewed to ensure it is:

- Consistent - Avoid production doubling while sales halve
- Accurate - Arithmetically correct
- Neutral - Neither overly optimistic nor overly pessimistic
- Documented - With clear statement of Assumptions
- Owned - Accepted by those who have to deliver it.

The review process should include consideration of alternative strategies and their impact on the overall and individual budgets.

Graphical representations, particularly when compared with current results and past trends, can help highlight inconsistencies. Percentage changes can identify areas which are out of line and can assist decision making.

Budgeting is an art, not a science. The objective is good actual results – not a good budget. The ideal budget process is one which enhances decision making by allowing for the sharing of information and views of the future.

## SUMMARY OF BUDGETING PRINCIPLES

1. **What do I want to do?** Sell, Produce or Administer
  - 1.1 Identify outputs and forecast them using the past as a guide
  - 1.2 Allow for
    - (a) Changes in internal working practices
    - (b) Changes in external environment
  - 1.3 Try to stabilise demand
  - 1.4 Ensure a consistent strategy
  
2. **What do I need to do it?** Staff, Materials, Space, Equipment
 

Staff

  - 2.1 Identify current spending
  - 2.2 Allow for volume changes
    - (a) Due to Sales
    - (b) Due to Efficiency
  - 2.3 Consider Price Changes
  - 2.4 Consider Contingencies

Materials

  - 2.5 Allow for manufacturing time
  - 2.6 Allow for stock level changes
  - 2.7 Allow for wastage

Space

  - 2.8 Impact of Volume change
  - 2.9 Availability and cut off points
  - 2.10 Price changes

Equipment

  - 2.11 Existing equipment
  - 2.12 Impact of volume change
  - 2.13 Replacement
  - 2.14 New requirements
    - capital
    - revenue
  - 2.15 Review useful lives
  
3. **Is the Financial Consequence Acceptable?**
  - 3.1 Adequate profit or acceptable loss
  - 3.2 Cashflow
  - 3.3 Timing
  
4. **What are the Risks?**
  - 4.1 Key assumptions
  - 4.2 Mitigation
  
5. **Review?**

## BUDGETING

Consider your department.

1. What Outputs do you have?
2. Do they have a sales value, if not consider how the organisation could value them?
3. What resources do you use? Split these into those under your direct control e.g. your staff; and those where you have influence but not full control e.g. allocations of building costs.
4. Analyse the resources and therefore their costs into those which vary with output volumes and those which are relatively fixed. Identify any critical volume levels which would cause a step change in resource needs.
5. Consider how you could reduce your budget process into a simplified model based on:

Output Volume	x	Price per unit	X
Output Volume	x	Variable Cost Per Unit	(X)
Fixed Costs			(X)
			-----
			X
			==

6. Consider the key risks involved. List them and consider mitigation or avoidance strategies and costs.



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David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website:

**FinancialManagementDevelopment.com** including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).