

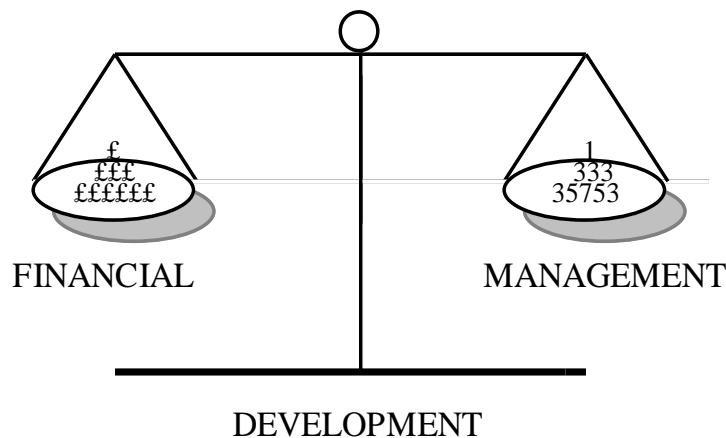
FINANCIAL MANAGEMENT DEVELOPMENT

Management Reporting

Budgetary Control

NO 212

BUDGETS



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.

BUDGETS

What is a Budget?

A Budget is the financial expression of the outcomes of an agreed, coherent strategy. Most organisations have a well established Budget procedure. Most managers complain about it. This paper sets out the inherent conflicts in the Budget process. It examines the objectives, the problem, the reality and the ideal format of a Budget system. It examines the need for, and uses of, reforecasts and poses a number of questions for all managers.

Why have a Budget?

Most textbooks suggest there are three reasons why people and organisations have budgets:

Planning - To set out the various requirements of the agreed strategy to ensure that it is feasible and that all concerned know the part they have to play. In particular the plan should include consideration of the cash resources available, the cash needs and ensure that any timing differences are covered by available facilities.

It should be a coherent plan including all parts of the organisation. It would be foolish if the Production Department decided to halve production next year while the Sales Department decided to double sales.

Control - Once a budget has been agreed it can be used a basis against which actual performance can be measured. The necessary management decisions can then be taken to alter actions in the light of the causes of the variations. It would be foolish if the sales force reported that sales were down by 50% but Production were not informed to reduce output. In addition the control process helps to identify the action required to correct for adverse budget variances. Profit is down because sales are down, but which sales, where and what is the reason?

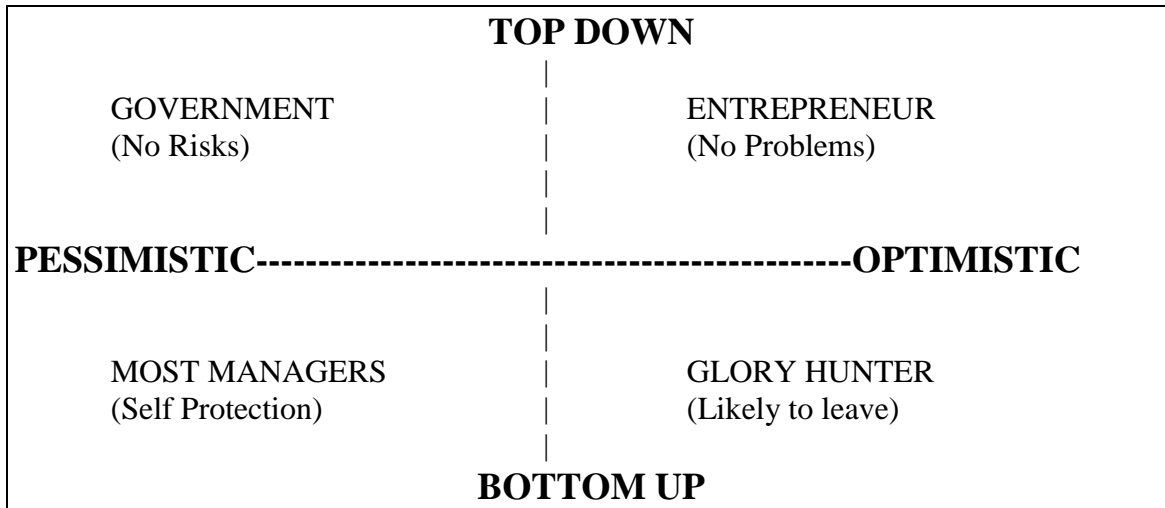
Motivation - Anyone who has done a boring job knows that it is easier if you set yourself targets. (I will try to finish the job before I go home etc.) In companies managers believe that if they set their subordinates targets they will strive to achieve them and thus do better than they would have done.

THE TEXTBOOKS ARE BOTH RIGHT AND WRONG

Yes these are the reasons to have budgets.

No the political games which surround the budget in real life prevent proper application of the budget objectives.

The objectives are mutually exclusive. A practical framework was developed to illustrate this by Alan Warner in the 1980's:



THE PROBLEM

If they are to be used to plan and control the budget must be realistic. However most managers would wish to give their staff a "stretching" target to motivate them to do better.

If they are to meet corporate goals then the budget requires input from senior management. If they are to be feasible in the light of marketplace activity they need input from the lower level workforce.

These needs conflict. No organisation (even a one person self employed sole trader) has a perfect budget system for all circumstances.

THE REALITY

The Entrepreneur

The individuals, or organisations which impose a top down, optimistic budget are seeking to cause change. "We will be the biggest...", "We will double sales", "Never mind the problems do what I tell you".

In some industries, in some circumstances this can be a very powerful motivator. If it coincides with a market upturn the entrepreneur can become very rich, very quickly and the organisation will flourish.

In the wrong circumstances it will sink without trace, or go out in a blaze of glory if it is a public company.

It is a high risk, high reward strategy.

The Government

Governments always know best. Therefore the Budget is imposed. Departments are told how much to spend, what to spend it on and transfers between headings are not allowed. This is a recipe for stagnation and slow decline. Nationalised Industries have always suffered from this in the UK. The system allows no scope for risk taking. It actively prevents growth, budgets normally being fixed by taking last year's spend and adding something for inflation. No new initiatives are taken because "there is no budget".

The Glory Hunter

"Do you remember Fred.....His department had the best budget sales anyone had seen.....pity he left before he could deliver it."
Either Fred knew he was going - probably to a better job far away; or he had to leave - once the actual figures showed the budget to be unrealistic.
There is no advice for Fred other than "stop it". To those with the difficult task of following Fred the advice is "get a new, realistic budget agreed fast. Otherwise the risk is that failure to deliver will be seen as your fault."

Most Managers

If you asked how fast you could run a mile and were told that your future career depended not on how fast you can run, but on the amount you beat your estimate by, what would you say? 20 minutes, a day, a week?

Thus when asked to give a budget most managers will play safe. Financial Controllers know they have put in 10% too much, so they cut the budget by 10%. This game has serious consequences. Unless the pessimism is controlled, and allowed for, the budget process becomes a political poker game.

THE IDEAL

The ideal budget is thus top down and bottom up.

In an ideal world the Budget would go through several iterations. The strategy should be set by senior management. Operational managers should then set out how it would be achieved in outline with broad costings. Senior management then review the total budget to ensure it meets shareholders needs. If it does not, and it rarely will first time, it should go back to the operational managers to review the necessary requirements.

This process should be repeated as many times as necessary. The only requirement is that the end product is merely a management tool. Of itself the Budget achieves nothing. To quote a wise Finance Director "Give me good results; not good budgets."

For good planning and control there is no point in a budget that is not realistic.

Assume you are a cost centre manager. You believe that next year you will need £100,000. You put in a Budget of £110,000 to be safe. This is approved and then your actual turns out to be £105,000. What do you report on your performance? Have you done well or badly?

In order to avoid this conflict, it is best to assume realistic financial budgets but set motivationally stretching targets. The two do not have to match up. Sales targets and Bonuses are often set unrealistically high. The Budget probably assumes 80% achievement for planning and control purposes.

FORECASTS

Once a budget is agreed, it is cast in stone. It cannot change. It represents a coherent plan which if all assumptions prove to be correct will result in specified outcomes. However, reality is that circumstances change. The Budget is a management tool. It is right that the actual results should be reported against the Budget. This does not mean that revisions cannot be made to help decision-making. It is vital that the budget is updated. Preferably it should be renamed - Latest Estimate; Updated Forecast etc.

These forecasts should be done as often as is appropriate to help management. Daily or even hourly in a Treasury Department or a complex industrial process plant. (Driving a car involves constant real time updating of forecasts as to where the car in front will be next).

The proper use of forecasts is to help managers - especially in other departments - to review their decisions and provide a better basis for control reporting than a budget which may be over a year out of date.

Proper forecasting involves proper analysis of variances from the budget to date. It must not be prevented from being used to help decisions merely because the outcome is now predicted to be different from the budget.

Avoid " I did not budget to buy an umbrella, so the fact that rain is now forecast is of no help to me." Buy the umbrella because it is right.

The Budget is not a blanket approval. It merely means that you need to justify deviations from the agreed Budget.

Do things because they are right not because they are in the Budget and tell people why if what you have done is different. This includes admitting and correcting mistakes, which is a key element of the control and improvement process.

Rev. DAVID A. PALMER BA (Financial Control) FCA CTA MCIPD

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).