BUSINESS TOOL KIT: THE BUDGETING PROCESS

There are a number of well-documented factors determining organisation success, client satisfaction, good service delivery, motivated workforce, good management etc. Underlying all successful organisations is an effective system of planning and control. The implementation and use of budgeting can make a valuable contribution to that process.

A budget is a plan expressed in financial terms. It stems from our defined objectives for the future, and acts as a target that we wish to achieve. Planning for our business tends to be more advantageous than running it as a 'seat of the pants' operation and effective budgeting helps in:

- motivation
- control
- management decision making
- risk minimisation

It is important to remember that when we budget we need to focus on the future, and in doing so a consideration of the past and present is necessary. A consideration of the future takes into account qualitative and quantitative factors, budgeting is not a solitary financial exercise and the budget should not end up an 'albatross' round our necks.

IN THE BEGINNING

Budgeting needs to be approached in a structured and considered way if it is to be effective and meaningful. We need to consider various factors in this respect such as:

- who to involve in the process
- when to begin the process
- when to complete the process
- what respective roles and responsibilities should be

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Who to involve
In some organisations just one person without involvement from the people who will have to implement it produces the budget. This lack of involvement and ownership usually results in meaningless budgets, contributing nothing to management, control or motivation within the business.

Each manager should be initially responsible for preparing his or her own budgets. Obviously overall organisational objectives, assumptions etc. will guide the manager in question, the finished budget will be subject to review and modification - real involvement is the key.

When to begin and complete
We should begin the budgeting process for the next year before our current year has finished. Since we are looking to the future an appreciation and evaluation of our current year is important, there is little merit in beginning the budgeting process right at the beginning or right at the end of the current year.

There is no set time to begin budgeting but as a general rule of thumb we will usually start budgeting for the next year after about 6-8 months of our current year has elapsed. The time scale needs to be considered in light of the complexity and size of our organisation. We need to strike a balance between relevance, accuracy and letting people be aware of the following years budget.

Roles and responsibilities
It is a good idea to consider who will be involved in the budgeting process, what action they will require and when this should be completed. Someone needs to co-ordinate the whole process and encourage people along as required. In a larger organisation more people will be involved in the process, whereas in a smaller organisation roles and responsibilities will be concentrated.

A budgeting timetable will consolidate all the above and needs to be communicated to and understood by all involved. Timings should not be too tight so as to make them impossible to achieve, nor should they be too loose that the whole process drifts.

WHAT TO BUDGET FOR

Our budget, a plan expressed in financial terms, will reflect our business objectives for the following year. The budget needs to be sales and not cost driven. We will need to draw up individual/key budgets, which will be eventually consolidated, into three master budgets:

- income and expenditure account (profit and loss)
- balance sheet – certainly for larger organsiations
- cash budget

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Some of the key budgets that will need to drawn up are

- income
- wages
- overheads
- capital expenditure

The income budget is our central budget and the one that is the most difficult to estimate. Our clients will not use our services based on what our costs are, we need to be conscious of what our client market will bear. All the other budgets - with the general exception of fixed overheads - will largely flow from the income budget.

INCOME

The income budget tends to be the most problematic to prepare. The main reasons being that this is an area of the organisation that is largely influenced by factors beyond our control.

Where income is from providing (paid) services then this will be made up of two elements, numbers of clients and price charged. These two elements are not usually independent of each other, for example we may be able to have more clients if we reduce our prices (or perversely increase the prices) - this relationship between numbers and price needs to be understood in relation to our products and services. We must also be aware of the following areas :

- market and industry trends
- competitor action
- constraints and limiting factors
- organisation strategy

Other sources of income can be from

- fund raising activities
- grants and donations
- contracts

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BUDGET DOCUMENTATION

Documentation makes an invaluable contribution to the budgeting process. The documentation takes many forms and addresses many issues:

- assumptions and parameters
- time tabling
- forecasting and input sheets

ASSUMPTIONS AND PARAMETERS

These are an intrinsic part of the budgeting process, and will form the basis on which the budgets will be set. Assumptions and parameters will be top down, bottom up i.e. strategic and operational ones. If individual managers are to input into the budgeting process then they need to understand and be aware of any underlying assumptions, for example prices, costs etc.

A record of assumptions and parameters is helpful when monitoring and reporting against the budget, as well as helping compile budgets in subsequent years. As with any documentation effective filing and retrieval is vital.

TIME TABLING

Any timetable should have certain features if it is to be effective, such as:

- it should be clearly headed
- it should state what is to be done
- it should state who is to complete the task
- it should state when the task is to be completed by
- it should be clear and logical

When we produce our timetable we need to consider holidays, evaluation of tasks, the sign off of the budget, phasing of the budget and reporting the final budget to all concerned.

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FORECASTING AND INPUT SHEETS

We will arrive at our budget information through a progression of steps and calculations. We should endeavour to make the process as straightforward and user-friendly as possible, carefully thought out 'working papers' can assist in this respect. Working papers can consist of graphs - for example, income trend lines - or a series of calculations with underlying assumptions.

The key to preparing and designing working sheets is to focus on what we want to achieve and keep this in mind. Involvement is fundamental to budgeting and we always need to maintain a dialogue (not a monologue) with all concerned personnel at all stages.

LOOKING FORWARDS

Apart from income we need to consider what are future costs will be. The usual start point is to consider where we will end up in the current financial year, and then use this as a basis to formulate the following years budget. In the area of overheads for example we may simply inflate our current years costs by an agreed percentage.

Costs and capital expenditure

Overhead and departmental budgets should be prepared for each major area of activity, either project based or functionally based. Involvement, ownership and dialogue with the concerned personnel need to be maintained.

In light of our future sales and strategic objectives we may need to produce a capital expenditure budget which is our budgeted expenditure on fixed assets. The budget will be made up of:

- approved capital projects where expenditure is still outstanding
- estimated expenditure on future capital projects

Producing our budgets should not be a purely mathematical exercise, otherwise we may as well leave it to one person and divorce ourselves from the process.

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MASTER BUDGETS

The budgeting process culminates with the preparation of the master budgets. The master budgets consolidate the individual budgets and present us with an overall financial picture, summarising the effects of our operational and strategic plans. The master budgets consist of:

- income and expenditure account (profit and loss)
- balance sheet – certainly for larger organisations
- cash budget

Income and expenditure account

This will show us our budgeted income, costs and surplus/deficit. We will be able to see the overall impact in financial terms of our future objectives, and usually the first produced Income and Expenditure account will not be our final version. We need to carefully evaluate our budgeted surplus/deficit, which may prompt us to look at alternative strategies or reconsider some of our key budgets.

Balance sheet

The budgeted balance sheet will be finalised after Income and Expenditure has been approved. The balance sheet helps us to evaluate our future financial position. A sound financial position is as crucial as profitability to our survival and prosperity.

Cash budget

Cash can be considered as the lifeblood of our organisation. Insufficient or inadequate control of cash is a primary reason for organisational failure. The cash budget will show us, in light of our budgeted objectives what our future cash and funding requirements will be. We will be able to take appropriate action in light of what the cash budget reveals.

USING THE BUDGET

Once we have finalised our budgets we need to phase them, i.e. convert the annual figures into when budgeted income and costs occur on (say) a monthly basis. Phasing will be influenced by

- seasonality
- anticipated expenditure - capital or otherwise
- strategic and operational objectives

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Our finalised budgets represent our desired and anticipated results. It is important that we measure and monitor our actual performance against our expectations. We should compare and monitor:

- to identify and act on deviations (favourable and unfavourable) from our budget
- to identify future problem areas in our business

We should aim to have and compare our 'actual' income, costs and profit figures as soon as one month has ended. Meaningful and effective analysis and interpretation of our results against our budgets make a vital contribution to the management and control of our organisation.

VARIANCE ANALYSIS

A technique that is commonly used in monitoring and measuring performance against budget is variance analysis. A variance is the 'difference between actual and planned performance' and can be favourable or adverse.

An analysis and investigation of variances is an effective way of detecting the causes of our business trends. Effective variance analysis operates within a system of management by exception that is we will concentrate on those events that are significant and exceptions to our plans. We will not waste our time on sorting through a mass of figures: variations point to the root of any inefficiency.

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