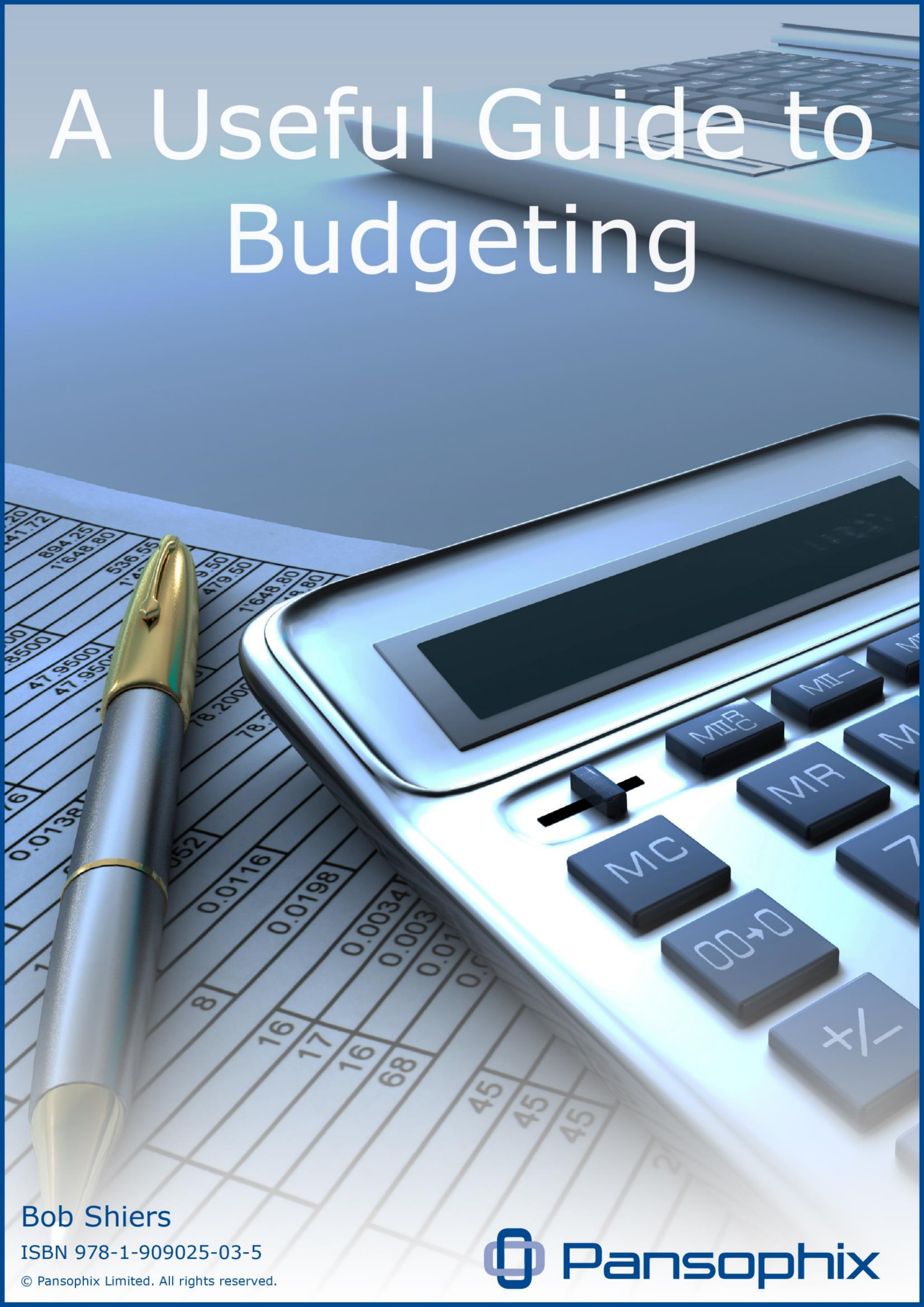
A Useful Guide to Budgeting



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A Useful Guide to Budgeting

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Introduction

Who should use this guide

During recent years, more and more organisations have devolved budget responsibility to junior and middle managers. Providing that the process is well managed and the new budget-holders are given appropriate information and training, this must surely be a good idea. This guide is intended for those junior and middle manager budget-holders and their direct reports. It does not attempt to cover multi-million pound long-term strategies, although the principles may still be useful. The guide refers to the workplace but the ideas are just as applicable at home, and domestic examples that many of us have in common are used to clarify some points.

Benefits of using this guide

This guide will enable you to:

- contribute towards the production of a budget that will help to manage the department/function cost-effectively;
- "manage by exception" and therefore save time and reduce potential stress;
- plan for the unexpected;
- make your case to senior managers.

Budgeting

The first part of this section covers the philosophy of effective budgeting. It is very important to approach the task diligently and with the right attitude. The later sections will help you through the process.

What is a budget?

A budget is a tool to help you to manage. It is your plan of action expressed in financial terms. It provides you with indicators to show how well, or otherwise, you are sticking to the plan.

Budgets normally cover one year but may also cover the duration of a project, which could last a few days or many years.

A budget may or may not be the same as a forecast. The distinction may be subtle, but generally a forecast is what you predict will happen due to external forces – the world happening to you. A budget is what you plan to make happen – you happening to the world!

Advantages and Disadvantages of Budgeting

Advantages

The preparation of a budget requires us to really think through our local plan and how it fits into the bigger picture and then to provide accurate data to make it happen. This is beneficial as it helps to prevent the "same old, same old" behaviour that often leads to stagnation and failure.

If a budget is carefully prepared and monitored, it will provide valuable indications as to how well or otherwise you are sticking to your plan. You may be responsible for, say, twenty items of income and expenditure, eighteen of which are running exactly to plan but two of which are not. Having a well-prepared budget will enable you to concentrate your energy on the two problem areas, where it will be most productive. Working without a budget is similar to driving around the country without reference to signposts, maps or sat-nav. You **might** end up in a different place and it **might** be good! Budgeting removes most of the guesswork.

Disadvantages

Budgets, like road maps, are designed to help you, not manage you. Circumstances may have changed since the budget was prepared and following it rigidly may not be a good idea.

If you discover an opportunity to do something really clever and entirely beneficial that is outside the budget, it would be a pity to watch the opportunity slip by because of over-rigid budget control.

The Culture of the Organisation / Office Politics

Padding (the mind game)

In some organisations the way budgeting is carried out encourages "dishonesty". I don't mean stealing of course, although the damage can be just as bad. If the culture of the organisation blindly rewards "beating the budget" instead of accurate budgeting, it is just possible that some budget-holders may "pad" their budget to make it easier to achieve. Padding is not an official term. It is a strange and often destructive budgeting ritual which goes like this:

1. The budget holder (BH from now on) is asked to provide a figure for how much something will cost; this often happens at very short notice.

2. When they have a figure in mind, they think of things such as:

   How safe is this?

   How sure of the figures am I?

   What if something changes?

3. They know that they will be unpopular if they overspend, so they add a little to their figure ("padding") to make it safely achievable. For some reason, 10% seems to be a popular amount of "padding".

4. Then they think about what their boss will say. If it is known that the budget holder's boss (BHB from now on) usually sends budget submissions back with words to the effect: "cut by 10%", BH will then consider adding a further 10% to cover this.

5. The figure submitted is now so obviously too high that BHB will probably make a note to request "cut by 25%" from now on.

This game can go on for years where any resemblance between budgets and reality is coincidental. Inaccurate figures are passed from generation to generation. I hope you don't believe this actually happens but some of you will know that it does. It becomes a silly mind-game which only helps your competitors.

Of course there is a better way, but before moving on to this, I would like to emphasise some of the pitfalls of "padding":

If BHB wins the mind-game, BH ends up with insufficient funds to operate efficiently. BH is in a no win situation and will come to work each day knowing they will fail to hit budget – not very motivating.

If BH wins and gets a budget that is over-generous and then everything goes according to plan, they will see under-spends on the management accounts, which will increase over time. BH will be reluctant to let the under-spend continue because they know that under-spends will ruin any chance of negotiating a good deal next time around; so what might they do? I would not suggest for a moment that they would waste cash to hide the under-spend. What sometimes happens is that expenditure is brought forward, so that items that might have waited until next year are purchased now, or items required by another department/function are secretly booked to the under-spending one.

This might not seem like "the end of the world" and might even be a good idea in certain circumstances; however, the fact remains that we are taking next year's expenditure out of this year's income, thus reducing this year's profit. It also corrupts the data for the future because this year's "padding" is now built into the system and will be used as the start point for next year. If an organisation could have made 10% profit and half the departments are running with 10% "padding", they will have "budgeted away" half their profit.

There may also be a more immediate and dramatic consequence. Even very small "padding" might make your organisation's quotation for a major contract uncompetitive. "Padding" can ultimately budget you out of business!

Proof

My favourite way to avoid what I have referred to as "mind-games" is to provide proof of your figures. It may take a little longer in the short-term but it always pays dividends. If asked to prepare a materials budget for making 100 loaves of bread per day, I would obtain figures for the size of the loaves, the exact amount of each ingredient required and its cost. Costs would be based on written quotations from several suppliers and take account of price review dates. If my BHB sent it back with "cut by 10%" written on it, I could confidently produce the figures on which my budget was based, and if they persisted, I would ask whether they would prefer fewer loaves or smaller ones.

Contingency planning

Years ago I worked for a very successful manufacturing organisation and my share of the revenue budget was £1m per week. The budget padding culture was not acceptable here. The Chief Executive explained very clearly what was expected of all budget holders. What he expected was accuracy.

All variances, favourable or unfavourable, had to be explained because, other things being equal, they represented inaccuracy. The prize was for accuracy, not beating budget.

Being new to the organisation, I asked how to budget for all the unknowns that could influence performance against budget. He told me to produce a contingency budget as well. At first I thought I would spend half my life producing budgets, but it was actually easy and extremely efficient. This is how it worked:

- All BHs were clear about what they needed to do in order to achieve the overall objective.
- They would work out what it would cost/earn if everything went according to plan and they would then prepare their budgets accordingly.
- They would then consider all the things that might not go to plan (contingencies); some might call this a guess, we called it our professional opinion!
- These were calculated to the best of the BH's ability and stated as a list of contingencies and what they might cost/earn.

It was brilliant. If things went to plan, or even close to plan, our budget reports showed exactly how close to plan we were; and if not to plan, which way to go to get there. This was simply because we all felt able to be totally honest when preparing our budgets. When something didn't go to plan we had hopefully (but not always) foreseen the possibility and submitted a contingency budget to cover the situation.

I saw three great advantages to this way of working:

1. Budget reports/management accounts were really meaningful; you didn't have to spend time working out whether a variance was a genuine problem or just "padding"; when you saw a variance, it meant that you were not on the track you intended to be on, for better or worse.

2. If the things that you hoped wouldn't happen did happen, the resources were there to cater for such a situation; similarly, if an opportunity arose to do something beneficial that was not in the original budget, funds were available to make it happen.

3. A contingency budget is like a life raft on a small boat; you don't plan to use it but it is instantly available to get you out of trouble; most contingency amounts (and life rafts) are not used and remain available for next year. For the reasons mentioned above, "padding" is generally spent, which is like buying a new life raft every year.

The Process

So let's consider what we must know and do in order to prepare a really useful and helpful budget.

The objective

We need to know what we must achieve. This guide is meant for the great majority of budget holders who are given (rather than decide) what they must achieve. This is not meant to imply any lack of consultation or autocratic senior management; it is a fact of life that a few people (directors/shareholders) will, quite rightly, decide the long-term strategy of the organisation and will break this down into the operational contributions required from all the departments involved, in order to achieve it.

Forgive me for stating the obvious, but budget holders must be 100% aware of their objective **and** how it fits into the overall plan. This understanding must include the overall benefits of success and consequences of failure to the whole organisation. For example, do we need to:

- Just survive to fight another day.
- Do more of the same – it works.
- Incrementally build on previous progress.
- Leap into the next generation, wipe out the competition and rule the world.

In my experience directors/shareholders are very good at quantifying the increases/decreases that they require and will have ensured that all the departmental objectives add up to the organisational objective. If yours are not very good at this, your task will be much more difficult!

Area of responsibility

It seems entirely reasonable and sensible to me that we need to be in control of things that we are held accountable for. I recall my frustration at having been asked to explain a variance over which I had no influence whatsoever. If the budgeting process is to achieve the benefits previously mentioned, the budget holder must be able to control the things that they are to be held accountable for. The only exception to this that springs to mind is the allocation of things such as "central costs".

For example, when running a factory, I was "charged" amounts for costs incurred by HR and Accounts departments, over which I had no control. The costs of these were apportioned to the operational departments by an agreed formula; HR costs were charged in proportion to the number of people employed in the department and Accounts costs were charged in proportion to the department's share of the turnover. This may not be 100% fair but life being too short to find a better way, it works for me.

Methods

There are several approaches to the budgeting process which I summarise here. You will probably use a combination of these.

Cost-plus budgeting

One time-honoured way of preparing a budget is to look at what it cost/earned last year and adjusting it for this year. Some will say "what's wrong with that?" The answer is nothing, provided that last year's figures were accurate (and not padded!) and that you want next year to be an exact re-run of last year. This can be very useful and relatively quick for situations that change very little and you understand very well.

Zero-based budgeting

I am a great believer in zero-based budgeting; although it is time-consuming and expensive, it is potentially extremely beneficial.

What I like about the concept of zero-based budgets is the requirement to momentarily forget the past and re-design the future. Some would describe this as "rub it out and start again". This method can help to:

- Show that we already had it right.
- Completely revolutionise a process.
- Consign the process to the dustbin where it belongs.

We must start by asking ourselves:

- Is this process necessary?
- Is there a better way of doing it?
- Do we need to do it ourselves?
- What should it cost/earn (worked out from scratch/zero)?

In other words, ask ourselves: if we were starting this job today, with no previous knowledge, how would we do it? This requires a great deal of lateral thinking. I like to consult the other people involved at this stage; they usually have a valuable contribution.

Priority-based budgeting

No matter how worthy are our demands on organisational funds, some may be more worthy than others.

Most departments have some budget items without which they cannot function and others which they can manage without – even if only in the short-term and even if it means a drop in service levels.

For example, at home items such as housing costs and food are first priority for most people, whereas holidays and nights out are second. Rather than exist without heat and a good diet, we may decide to forget the holiday this year; ie drop one "desirable" budget item completely rather than skimp on other "essentials".

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Gathering Data and Proof

Like some other things at work, there are two ways to prepare a budget – properly or not at all! A well-prepared budget is useful and makes life easier. A poor job will probably do you more harm than good.

This is one of those times when detailed and thorough planning and research will pay handsome dividends. I have known people who have been too busy to spend sufficient time to get the full facts and then spent the next twelve months wishing that they had taken the trouble to get it right in the first place. You may have heard the old "5Ps" saying: perfect planning prevents poor performance.

It is not good enough to simply look at how much you spent on an item last year and increase it by the current estimate of what inflation might be. Some items increase in price much more quickly or slowly than the average. Some items may go down in price.

It is also important to know when price reviews will take place. This might be when your suppliers review what they want you to pay or equally when you review what you want your customers to pay. It will obviously cause you a great deal of pain if you suffer an unplanned price rise only one month into a one year budget.

Some costs may well be worked out for you as "standard costs". A good example of this from my former life was the "standard labour rate". A clever accountant studied our statistics and calculated how much it actually cost to employ a production line operator. In addition to their wages, we also had to pay for things such as sick days, holidays, training, tea and restaurant subsidy, transport, national insurance and so on. This was a great help to me and the team leaders. All they had to work out was how many people they needed and apply the standard cost. I am sure that there was a little "swings and roundabouts" at work here, but the principle served us very well indeed.

Consultation

When gathering data for your budget, it is generally a good idea to consult with the people actually doing the work. This assumes that you keep them well informed about the issues that can affect their work. There may still be some value in consulting with people who are "kept in the dark", but perhaps not too much. There are two main reasons for consulting with the people involved in doing the work:

1. They know every intimate detail of their job. They can tell you what will improve it and what will slow it down. Even if you are only recently promoted from doing the job yourself, you will soon become out of touch with the detail of the current working practice. Things change and evolve all the time and your people can, if encouraged, offer all sorts of valuable data and ideas.

2. People generally like to feel involved and contribute brain as well as brawn. Most of us spend more time each day at work than with our loved ones and, however tough some people might like to appear, there has to be something more that the pay cheque, doesn't there?

If we feel involved and valued, we are more likely to feel and act like part owners of the job. If times are difficult, we will strive to keep everything going and take pride when it does. If, on the other hand, we are treated more like "cogs in the machine", we are more likely to act as such. We may see the process begin to go wrong and know how to make it better, but cogs aren't expected to think and make suggestions, are they?

When something has gone seriously wrong, you may have heard someone say: "I could have told you that would happen" or words to that effect. Maybe they could or maybe they couldn't, but it wouldn't have cost much to find out.

Limiting factors

It is easy to assume that the cost of doing something increases in proportion to the number of times you do it, and sometimes it does. However, sometimes it does not, for example:

You own one truck which can do 20 deliveries a day if well organised. The truck is the limiting factor. Suppose you want to do 25 deliveries a day and therefore you purchase another truck. You now have a 25% increase in deliveries and a 100% increase in truck costs. If you are in charge of deliveries, you would naturally understand and manage this, but sometimes the limiting factor may be something you can't see or control. It could be that the people who produce the goods you deliver are at maximum efficiency producing 25 deliveries a day and their costs are a hundred times greater than yours. You would have to operate very inefficiently to enable a much larger department, in this case production, to operate efficiently. Sometimes that's the way of things.

I would imagine that in reality you would find five customers willing to accept deliveries outside normal hours and operate with one truck (and one very well paid driver!).

Profiling

This is about breaking down annual income/expenditure over the time periods in which they will appear.

Some income/expenditure items are spread evenly throughout the year, so once you have worked out how much they are, you can simply divide by the number of periods that the budget covers. For example, divide by twelve for a one year budget divided into twelve calendar months or divide by thirteen for a one year budget divided into thirteen 4-week periods.

However, some things are "seasonal". For example, when I was a full-time trainer, it was very difficult to find work during the school summer holidays and a week either side of Christmas. Our income had to be budgeted over ten months, not twelve. This meant that our variable costs were also incurred over ten months but of course not the same ones. Profiling your budget will help to prevent any nasty shocks.

Much of the hard work can be eradicated by using spreadsheets which will summarise your monthly and cumulative positions for you – providing that you use good data in the first place!

Having profiled your budget, you may well find that at times you will need to spend a lot more than you receive, or vice-versa. If you are part of a larger organisation, it will be a great help to your Finance Director to know this in advance. It will enable them to arrange overdraft facilities / investment of spare cash in good time. If you are the one who will have to arrange the overdraft, it is worth remembering that sensible lenders are much more likely to support someone with evidence of good forward-planning than someone who is already in a muddle which they should have foreseen. Even if they do support the person in a muddle, the rate they charge will reflect the perceived risk.

Reporting / Communication

Everything we have said so far will assist in the production of management accounts, also known as budget reports. These will show, item by item, what we planned, what actually happened and the gap, if any, between the two.

Some of us look forward to receiving these and study them in great detail. Others say we should get out more! Seriously, we should be able to see at a glance how we are doing. If you receive something the size of "War and Peace", you must be able to go quickly to the most important sections. It should be like looking at the speedometer on a car – you can see at a glance how fast you are going. You should not have to measure the distance travelled in a given time and do a calculation. If your management accounts are difficult to understand, have a friendly word with your management accountant. With modern IT systems, they can probably give you exactly what you need, but they are not mind readers. It could be that everything you need is there but you need some help finding it.

Thanks partly to IT, management accounts are usually available very soon after a period end, providing that everyone has supplied all the required data. This is beneficial because the quicker we can spot a variance, the quicker we can fix it. I once knew a very clever management accountant who could spot an important variance even before the complete accounts were ready to distribute. He would give me a call and say something like "I haven't got all the figures yet but you might like to have a look at ……………". He wasn't always right but I believe he saved us a small fortune.

Once you have received and understand your monthly figures, it is important to communicate the relevant parts to the people "at the sharp end" as soon as possible. Most departments/functions have a monthly team meeting of some kind, usually taking place just after last month's results are available. This is the perfect opportunity to keep people up-to-date with the figures and to seek ideas for improvement, if required.

Make it interesting

Pages of figures are not everyone's cup of tea. A good idea is to make all the figures available to anyone who wants them but just select the most relevant parts for presenting at the meeting. Figures should be presented in an easy-to-understand format. Pie charts and bar charts are quite popular, as are comparisons with relevant figures from previous accounts.

For example, you might say that "although we are a fraction behind budget, we are doing much better than last year".

Motivation is an important factor in achieving results and the way we pass on the figures can really help, or hinder, effective communication.

When everything is on target, it is easy to pass on that fact in a motivational way. The fact that you are pleased will show and is half the battle. Adding a few specific examples of what made it work so well, the benefits to the organisation and some credit where it is due, will all be motivational for most people.

Briefing bad news can be a bit more difficult, but can be equally motivational, if done properly. When we miss a target, there is usually a good reason. It is extremely unlikely that everyone purposely decided to do badly this month, and even if they did, there will be a reason for that too. Very often in my experience, when a well-run and motivated team has a poor result there will be some outside influence at work which is beyond the team's control. An unexpectedly long cold winter could increase sales of heating fuel and winter clothing but damage the sales of sun-cream and barbeques.

It could even be that you overlooked something when preparing the budget.

The important thing is not to let it have a de-motivating effect on other people at a time when you need their very best work.

If you are briefing a shortfall due to some external force, it is important to recognise the reason for the shortfall. It might be that it was only the team's hard work that prevented things being even worse and that praise is called for.

One of the worst things I have seen in a difficult period was when a company director hijacked a team meeting in order to give the team "a good hiding" about a missed target. The key message, repeated many times, was that they must try harder and do better. The team was normally very successful and loyal. One of the team eventually stood up and asked politely: "we are already doing our best, what exactly do you want us to do to make it better?" The director appeared to have no idea whatsoever so replied, louder and with gesticulation: "just do better". Others, believing it reasonable to ask a director for direction at this difficult time, also started to ask for guidance. The director, having nothing helpful to say, eventually stormed off leaving the team saying things like: "if that's what you get for doing your best, why bother"?

It took the team leader a while to restore team spirit.

Conclusion

I hope this has been useful and given you some additional "food for thought".

Spending (a reasonable amount of) time producing quality data and keeping it up-to-date will help you to produce a useful budget, which in turn will reap rewards.

It will also make your department/function more robust, if outside forces conspire against you.

Happy budgeting!