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Making Budgets Work

www.at-accountancy.co.uk
enquiries@at-accountancy.co.uk
T: 01543 897820

No 21 Centrix@Keys
Keys Business Village
Keys Park Rd
Hednesford
WS12 2HA

Making Budgets Work

⇨ Using budgets to enhance performance

Overview

Budgets are a valuable tool for managing performance within any organisation, underpinning every part of the business from personnel to marketing, product development and operations to IT. However, there is a paradox. Despite their widespread use and the need to include budgets in all areas of business operations, budgets are often resented and their full potential not realised. In some cases, managers disregard or ignore budgets altogether, believing that they lack value or credibility, often with disastrous consequences.

A budget is simply a financial plan showing how organisational objectives for revenue, profit and stakeholder return will be achieved. The budget needs to meet strategic and operational objectives, the most important of which are revenue and profitability targets. To use budgets for financial control they must enable *actual* results – the reality of the situation – to be measured against a plan for how the operation should proceed. Consequently, systems should be established to permit routine monitoring of the organisation's finances. Despite its daunting reputation, budgeting is relatively easy to master, methodical and essential to achieving strategic goals.

Benefits of budgeting

The great benefit of budgeting is that managers gain a realistic vision of the development of their business. This in turn provides greater control in key areas. Another benefit is the ability to monitor trends over time. Analysis of a twelve-month financial performance with sub-totals every quarter can highlight:

- **Escalating costs** that are either occasionally or consistently higher than expected.
- **Sales performance:** did the business do as well as expected? If not, why? Was the sales profile as expected or did it result from unique individual factors?
- **Changes in profitability** against budget as well as against targets for each month. Falling sales volumes, falling prices (or rising discounts) as well as rising costs could cause lower profits and budgeting will illuminate these root causes.

It is often said that you cannot manage what you cannot measure. Budgets allow all operations to be understood and measured, increasing control and the likelihood of success.

Action checklist: budgeting

Set the scope of the budget (priority areas)

Budgeting techniques can be applied to the following areas:

Sales. This is the foundation for the budget and the business, essential for the effective organisation of resources. It should include the number of units to be sold at a given price, including discount, and may be broken down by timing, area, sales channel or product line. It needs to realistically assess likely sales based on reliable market research. Depending on the product and nature of the business, sales budgets are typically produced on a weekly, monthly or quarterly basis, as well as in an annual format, so progress and expectations can be monitored and updated.

Variable costs. These are costs that increase or decrease in direct proportion to changes in sales volume. Examples of variable costs include the materials used to make a product or royalties payable on each sale.

Production. The production budget follows the sales budget and includes direct, variable costs that depend directly on the level of sales. The production budget is useful for managing suppliers and ensuring that you have the right resources ready at the right time.

Fixed costs. These are costs that remain unchanged in the short-term despite changes in sales volume. These costs tend to be related to *time* rather than volume and they include monthly staff costs or monthly expenses such as rent, lighting and heating. Controlling these costs tends to be the responsibility of more senior managers within an organisation and they should be managed carefully: reducing them is usually more difficult and has significant implications for the whole of the business (for example, reducing staffing levels or moving premises). However, if that is where the problems lie and the business is carrying a level of fixed overhead that is too great, then that is where action needs to be taken.

Overheads. Overheads vary considerably and include fixed costs such as staff costs, telephone and premises. Depending on the type of business, they can be allocated for each product or, alternatively, budgeted as an overall figure for the business. The important point is to choose the most useful approach and be consistent.

Budget early

Clarify your financial requirements as soon as possible. Plans and expectations may need to be discussed; it is always dangerous preparing budgets 'in isolation', without discussing them with financial experts and others involved in the business.

Identify the appropriate budget period

Periods vary according to the needs of the business – in some industries; it is helpful to have a weekly budget, which may be unnecessary in different circumstances. Finances may need to be very tightly monitored and controlled, requiring a short budget period – though this is costly, with financial forecasts then being made more regularly. However, the conventional period to budget for is normally a year, sub-divided into quarters or months, and, unless a business deviates significantly in its operations or demands from the average, it is wise to adhere to that timescale. If the budget is set for the year, then budget reviews normally take place each month, often with a detailed budget review taking place every three or six months.

Seek advice and communicate

Budgets are of interest to people inside and outside the normal running of the business. For example, bankers and shareholders may not be engaged in routine operations, but may still have valuable advice. Parts of the budget, such as sales volumes, will also be relevant to suppliers, whilst aspects such as staffing levels and training will be important to personnel managers. Distinguish between those people and times where information and advice are needed, and those parts of the process where clear communication of decisions is needed.

Include a cash-flow forecast

Budgets provide a valuable starting point for preparing a cash flow forecast. Expectations of growth and costs can be undermined by the realities of cash flow. One potential trap of budgeting is to assume that after a sale the cash is there and the business can roll on: in reality, bad debts, overdrafts and terms with creditors and debtors can all undermine the budget.

Budgets are a central aspect of business strategy, enabling organisations to plan their allocation of resources, as well as providing a guide to the health of the business.

Be consistent

Once set, a budget provides a plan for the whole business that should rarely be altered. If actual results differ significantly over a sustained period from the budget, then it might be wise to review it, including a wiser forecast for the future. This will ensure a reasonable financial plan is in place; it will also highlight strengths and weaknesses in the business as results are assessed against planned performance.

Act on the budget information

Too often, managers ignore the information that they are being given, failing to analyse its significance and work out tactics to keep the business on course. Monitoring actual performance against the budget, analysing the causes of any variations and taking corrective action is important in making the budget workable.

Many people view budgets as being divorced from reality – an academic exercise of little practical value, and the temptation can be to ignore them. In reality, budgets need to be constructed as carefully and accurately as possible and then regularly used as a guide to the health of the business. If that health seems to be failing then the causes need to be understood and action needs to be taken. Common failings include preparing:

- Pessimistic budgets, as they are easily achieved and the risks of failure are reduced. They also discredit the budgeting process and make the business unprepared for action.
- Optimistic budgets can be equally flawed. They also lead to damaging and false expectations. This means that the business will be financially unprepared for a low level of business, with potentially disastrous results.

Prepare different scenarios

Following on from the previous point, a popular technique is to set three budgets: optimistic, realistic and pessimistic. This is useful for start-up businesses that lack sufficient experience to make forecasts reliably. It is also useful for organisations that may be affected by external factors that become apparent late in the budget period (such as decisions by major competitors to withdraw from the market).

The value of different scenarios lies in seeing what the minimum requirements are to run the business, and *how, where* and *when* these will need to expand in order to achieve the optimistic target.

Focus on profitability

Concentrating on products and services with the best margin will protect or enhance profitability. This might involve, for instance, redirecting sales and advertising activities. When reviewing the budget you may also want to:

Decide how to treat the least profitable products. The least profitable products often drift, with dwindling profitability. Decisive action is needed to turn around a poor performer by reducing costs, raising prices, altering discounts or changing the product, or abandoning it altogether, to prevent a drain on resources and reputation.

Ensure new products enhance overall profitability. New products often focus on market need or production, with insufficient regard to the financial issues of cost, price, sales volume and overall profitability, which are inextricably linked.

Manage development and production decisions. The amount spent on research, as well as the priorities and methods used, affect profitability. Too little expenditure may result in larger costs in the long-term. The shelf life and appeal of a product need to be considered when deciding to continue or discontinue it. Also, the number and quality of suppliers is another important issue. Decide what the buying policy should be (such as a small number of preferred suppliers or a bidding system among a wider number of potential suppliers). Other issues to watch out for include controlling delivery charges, monitoring exchange rates, improving quality, reducing inventory and improving production lead times.

Ensure that decisions are customer focused. Decide how to derive greater value from existing customers and products to enhance profitability. Consider:

- How customer loyalty (and repeat purchasing) can be enhanced.
- How the sales proposition can be made more competitive.
- How existing markets, sales channels, products, brand reputation and other resources can be adapted to exploit new markets and new opportunities.
- How sales expenses can be reduced.
- How the overall effectiveness of marketing activities can be increased.

Avoiding problems

Remember that everyone is responsible for playing their part in achieving the budget. Financial decisions should not be left to experts in the finance department. Financial issues and techniques affect all managers and are influenced by everyone.

Financial expertise must be widely available. Everyone in the business needs to understand the financial challenge they face, how they can achieve their financial objectives and how they are progressing. People need the information and expertise to routinely make the best financial decisions and to consider all relevant decisions from a financial perspective.

Avoid weak budgetary control. Often, budgets are used merely to assess performance, whereas their real value lies as active tools to inform financial decisions. Budgets should not be cut without giving sufficient thought to how this will affect other parts of the business.

Consider the impact of financial decisions. Do not under-estimate the impact of finance issues upon other departments and decisions.

Understand the impact of cash flow. Issues of cash-flow and the time value of money are often ignored by non-financial managers, to the detriment of the organisation. In the worst case, this may result in the business becoming insolvent.

Know where the risks and areas of greatest sensitivity lie. Understanding where risks lie and what needs to happen to reduce risk is an important part of the process of financial decision-making. For example, not only does one need to know where the break-even point is, but also how and when it will be reached.

Key questions

- Is there a positive attitude in your organisation to budgets and budgeting?
- Are the most effective and relevant performance measures in place to monitor and assess the effectiveness of financial decisions?
- Have you analysed key business ratios recently?
- Is decision-making focused on the most profitable products and services, or is it preoccupied with peripheral issues?
- What are the least profitable parts of the organisation and how will these be improved?
- Are decisions focused on improving profitability, as well as benefiting customers? Too often, attention is given to non-financial objectives, such as increasing market share, without adequate consideration of the financial risks and alternatives.
- How efficiently is cash managed? Do your business decisions take account of cash considerations, such as the time value of money?

Dos and don'ts

Do:

- Be realistic but challenging: budgets should have a realistic and aspirational element.
- Take action, drastic if necessary, to stay on course and achieve or improve on your planned results.
- Communicate constantly, explaining why the budget is important, how it will be achieved and how people's efforts are affecting financial results.
- Develop key performance indicators (KPIs) such as ratios that are budget-related and graphically highlight performance in critical areas of the business.
- Consider linking employees' remuneration to performance against budget, with the intention of reinforcing desired behaviours (such as a greater effort to sell or control costs).

Do not:

- Focus exclusively on past performance when setting or reviewing budgets – consider what the future holds.
- Be overly optimistic or pessimistic. Use different scenarios if that would be useful, but try to reach a consensus on what is likely.
- Ignore the reasons for performance that is better or worse then expected. Investigate variances in expected performance.

Things you can do

Set the budget parameters

This includes the timetable and format for the budget, as well as other material factors such as a view on the likely exchange rates prevailing in key markets or the general economic background. Leaders in established businesses often give guidance on how the market is likely to change, on how sales should change (e.g. grow by 3%) and on what changes are likely to affect costs (including expenses and overheads).

Discuss and research the business

Key assumptions are derived and the shape of the budget is formed. This not only involves looking back at previous years but also discussing with others what changes are likely in the coming period. Key elements that are addressed include:

- Pricing and discounts.
- Sales volumes and sales profile (meaning how sales will be split between product lines, territories, time periods or departments).
- Production costs.
- Distribution costs.
- Personnel costs.
- Costs of other support functions (such as finance and IT).
- Other overheads.

Obtain feedback on the first draft

This will ensure that it is realistic and owned by as many people as possible. Discuss concerns and attempt to reach a consensus that could achieve the business's full potential.

Finalise the budget

The information needs to be assembled and included. It is then worth a final check to ensure that every aspect of the budget is reasonable: it may seem logical, but a key question is often how different it is from the previous years. Significant differences will need to be explained. It is also worth checking the arithmetic and ensuring that the figures add up! Finally, the presentation of the budget is important: it needs to be clear, understandable, succinct – but with supporting documentation (particularly useful for reference later in the year) – and attractively presented. Although it sounds trivial, good presentation will go a long way to instilling confidence.

Explain the budget

Obviously the information is sensitive and should be treated in confidence, but it is also worth explaining the financial plan so people understand what is required in each area. Explaining relevant aspects to stakeholders (including suppliers) is also useful, as it gives them an indication of likely developments in the future.

Further action

Use the following table to identify areas for further development.

Issue	Response	Further Action
Do the right people understand the budget and its consequences?		
Does your budget reflect where the business will be going – or does it simply reflect the past?		
Does your budget draw attention to areas of the business that aren't performing or that need to be changed? How easy is it for problems in your business to be clarified in the budget, for example, through useful KPIs (Key Performance Indicators)?		
How sophisticated is your budget? For example, does it incorporate discounted cash flow analysis and set parameters for certain ratios? Often, budgets do little more than outline how much revenue should be generated versus expected costs.		

For Further Information or to Arrange a Consultation

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