



A PRACTICAL GUIDE TO ORGANISATIONAL BUDGETING

EXTRACT

BE HEARD.
BE RECOGNISED.



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1. ASSESSING THE CURRENT POSITION

1.1 RESOURCES

1.1.1 Budgeting: A quick refresher

A budget is a plan documenting the future needs, uses and allocation of resources. Typically, a budget is a financial plan, but budgets can also incorporate non-financial outcomes including customer, employee, business process and environmental metrics.



In contrast to financial reports, which look at historical performance and results, budgets are forward-looking, typically for the coming month, quarter, year or even for specific projects.

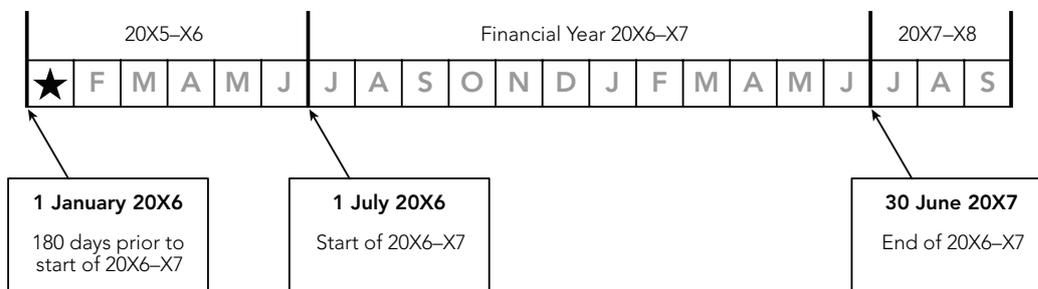
TIP

Budgeting, by extension, is the whole process of creating, implementing and reviewing a budget. The budgeting process can take many months and typically, takes place over three consecutive financial periods.

Timeline

The figure below provides a timeline of a budgeting process. You can see that it starts well before the financial year that the budget relates to. So, at any particular time you may be preparing budgets for the future, as well as reviewing performance against current budgets.

Figure 1: Timeline of the budgeting process (180 days prior to start of 20X6–X7)



Who does budgeting?

Budgets are part of everyday life, and are used by individuals, organisations and governments. For example, you probably have a budget for your weekly or monthly shopping expenses. You would probably also be aware of the annual federal government budget, which estimates future revenues and allocates them accordingly to the various government departments and initiatives for the coming year(s). In the same way, organisations (both for-profit and not-for-profit) have budgets to help them achieve their financial and non-financial goals and objectives.

A large listed company may begin the budgeting process for the coming financial year six months prior (or even earlier!) to the start of that financial year. The budget is then implemented during the particular financial year and the final reviews of the budget may still be taking place in the early part of the following financial year.

As such, different phases of the budgeting process may be happening at the same time (e.g. planning for the next financial year may be occurring at the same time as reviewing the current financial year's performance against budget).

Why is budgeting undertaken?

Budgets help create and maintain financial discipline. They also help to align an organisation's day-to-day operations with its end goals or outcomes. A budget is therefore a useful control mechanism that assists with the implementation of strategies and, ultimately, the achievement of objectives.

Budgets also promote responsibility and accountability (responsibility accounting). In large organisations with many divisions, each division is typically responsible for developing and operating within their budget. Remuneration and rewards are typically linked to the division's actual performance compared to its budget, thus holding the relevant personnel accountable.

Budgets can highlight and reveal potential areas of concern well in advance by clearly showing the expected inflows and outflows of resources (for example, showing the need for cash when a major purchase is going to occur).

From a day-to-day operating perspective, cash flow is also crucial. For example, if an organisation pays its creditors on 7-day terms, but only collects cash from debtors on 30-day terms, the organisation's cash flow budget will reveal a shortage of cash to pay for day-to-day operating expenses. This shortage will need to be covered, so the organisation will look at ways to improve the situation before it becomes a significant issue (for example, collect debts quicker; ensure a bank overdraft is in place; inject more equity from shareholders).

Who uses budgets?

In an organisation, budgets can be used by different people in a variety of ways:

Board of directors	<ul style="list-style-type: none"> • To communicate expected results to external stakeholders, such as shareholders. • To compare actual performance against budget.
Senior management or Division heads	<ul style="list-style-type: none"> • To align operating activities with the strategic objectives. • To communicate expectations to internal stakeholders, such as line managers. • To set and measure remuneration and rewards.
Finance staff	<ul style="list-style-type: none"> • To provide relevant inputs and outputs for line managers, division heads and senior management. • To create and distribute reports comparing actual performance against budget.
Project managers	<ul style="list-style-type: none"> • To ensure projects run to schedule within financial and other constraints.
Employees	<ul style="list-style-type: none"> • To understand the resources available and the performance expected of their division and the organisation. • To measure remuneration and rewards.

Budgeting and the accountant's role?

The accountant's role in the budgeting process largely depends on the size and nature of the organisation. Accountants often perform the dual roles of information gatherer and information provider, as well as advising and controlling actions and decisions. Accountants often help create systematic processes that consider important assumptions for revenue and cost estimates and help identify relationships between action and levels of expenditure.

In a small organisation, where there is only one accountant or financial controller, the accountant typically liaises directly with senior management to prepare all relevant budgets and provide subsequent performance reports.

In a large organisation, where there may be finance staff in each division (as well as a centralised Finance Department), a typical accountant's role may only focus on a small section of the overall budget (e.g. the operating expenses for a particular division or responsibility centre).

However, all organisations rely on the accountant to understand and provide the relevant revenue, cost and operating assumptions and relationships that underlie the budgeted figures.

1.1.2 Purposes of the budget

Budgets can have a positive effect (for example, by providing direction and something to aim for); however, they can also be negative (for example, if they appear to be asking for too much with too little resources).

Planning	Budgets are plans for the allocation of scarce resources that help ensure the most effective outcome is achieved.
Coordination	Budgets assist in coordinating and linking resources from all areas of an organisation to help achieve a common goal or objective.
Communication	Budgets – comprising resource allocation, actual results and performance evaluation – can support decision-making by communicating relevant and useful information to managers and other users.
Motivation	Budgets document specific targets and facilitate the measuring and reporting of actual performance, such that success can be rewarded (or failure can be quickly addressed).
Evaluation	Budgets allow actual performance to be compared against expected performance, such that discrepancies can be identified and the underlying causes or reasons addressed.
Control	Budgets document the planned allocation of resources and so provide a control mechanism to ensure that any deviations identified are quickly attended to.

1.1.3 Budgeting for different entities

Budgeting outputs will be different for different types of entities.

Not all the budgets described in this course will be needed for all organisations (e.g. service or trading firms will not require a production budget). Some organisations may actually prepare additional budgets or budgets that focus on different issues (e.g. research and development).

More likely, it is the level of detail and the underlying process that will vary. For example, one organisation may be happy with one single general expenses budget, whereas another may drill down to the individual line items for each department or responsibility centre (such as administration, sales, marketing, and information and communications) to prepare the same budget.

Budgets and the budgeting process for different types of entities

Budgets and the budgeting process are different for different types of entities.

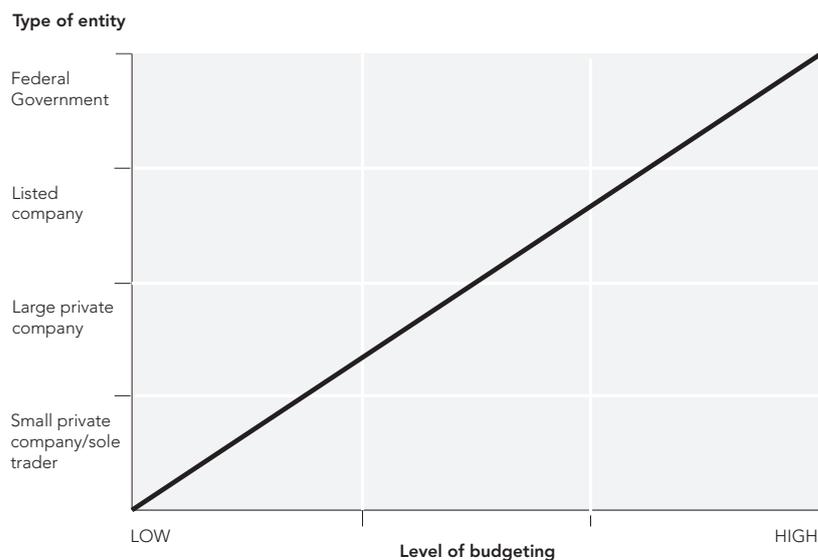
Individuals	<p>A budget may simply be an inherent understanding that you cannot spend more than you earn each month.</p> <p>However, budgets can also be prepared to take into account ad hoc expenditure over a longer period of time, such as holidays and the purchase of a car. The budgeting process is usually quite informal, with less analysis and evaluation taking place after the period.</p>
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Organisations	<p>Budgets will differ between different types of organisations, such as small-to-medium enterprises or large corporate bodies, as well as not-for-profit organisations.</p> <p>As the size and complexity of the organisation increases, so too does the level of budgeting and the reliance placed on it. While for-profit organisations typically focus on the financial outcomes, not-for-profit organisations are also concerned with their non-financial objectives.</p>
Governments	<p>The three levels of government (local, state and federal) prepare detailed budgets which undergo extensive public scrutiny – especially those which reflect changes in taxation policies.</p> <p>Such budgets provide a good indication of the strength of the national economy and reveal the revenues expected, as well as the allocation of funds to various departments, infrastructure projects, and other public amenities and initiatives.</p>

Budgeting and the size and complexity of an entity

This diagram highlights that a single, uniform approach to budgeting may not be relevant at all stages of a business’s life cycle. For example, as a small business grows it may demand greater detail in its budgets to allocate resources effectively.

Figure 2: Relationship between budgeting and the size and complexity of an entity



Budgeting for different categories of organisation

In this course, our focus is on organisational budgeting. For the purposes of budgeting, most organisations can be differentiated into three categories:

Service	<p>These organisations earn revenue by providing a service to clients.</p> <p><i>For example, a lawyer will provide legal advice and other services to clients and charge for their time as well as any on-costs.</i></p>
Trading	<p>These organisations earn revenue by purchasing goods and reselling them to customers.</p> <p><i>For example, a shoe shop will purchase shoes from manufacturers, and then on-sell those shoes to retail customers (usually at a marked-up price).</i></p>

Manufacturing	<p>These organisations earn revenue by producing goods and selling them to wholesale or retail customers.</p> <p><i>For example, a manufacturer of steel rods will purchase raw materials, manufacture the product according to specification, and then sell the finished product to customers such as hardware stores.</i></p>
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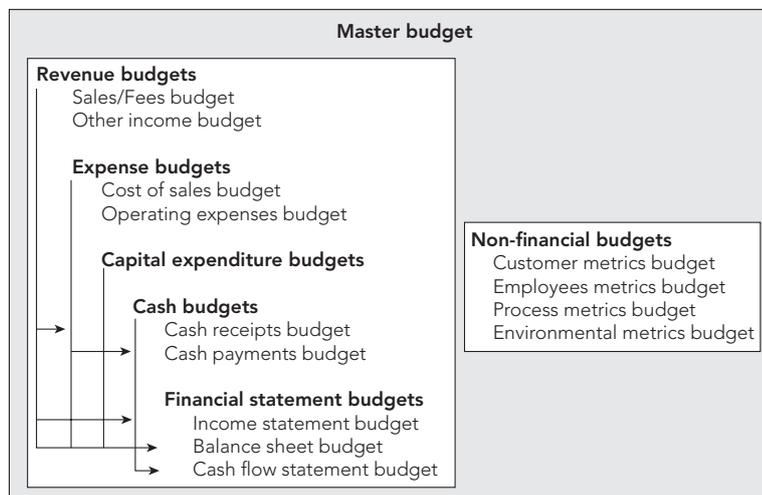
Budgets are typically the same for each type of organisation (i.e. service, trading, or manufacturing). However, minor variations exist as each type of organisation has different needs and objectives.

1.1.4 Types of budget

There are many different types of budgets (which we'll look at below). Most relate to financial objectives, although budgets can also refer to non-financial goals.

These budgets combine to form the master budget which is the term given to the overall set of budgets. The flowchart below reveals the inter-relationships that exist between individual budgets within the master budget.

Figure 3: The interrelationships that exist in the master budget



Revenue budgets

These budgets document the revenues or income expected to be received by the organisation, and include both the expected volume of sales and the price of sales.

Sales budget (fees budget)	<p>Trading and manufacturing organisations typically prepare sales budgets (e.g. <i>number of units multiplied by unit price</i>).</p> <p>Service organisations typically prepare fees budgets (e.g. <i>number of hours multiplied by hourly rates</i>).</p>
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Example: Sales budget for a trading organisation

Product	Units	Approximate Price	Total Revenue
A	6,000	\$105.83	\$634,980
B	33,000	\$50.91	\$1,680,030
C	380,000	\$8.00	\$3,040,000
Total			\$5,355,010

Example: Fees budget for a service organisation

Job	Hours	Approximate Hourly Rate	Total Revenue
1	4,950	\$148.08	\$732,996
2	3,925	\$148.66	\$583,491
3	7,700	\$153.51	\$1,182,027
Total	16,575	\$150.74	\$2,498,514

Other income budget	Many organisations also have other income sources, such as interest income or rental income, and these items should also be included in the revenue budgets. Ad hoc events such as the sale of some non-current assets may also generate additional 'other' income.
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Example: Other income budget

Item	\$
Interest income	\$16,000
Rental income	\$44,000
Sale of non-current assets (land)	\$120,000
Total	\$180,000

Expense budgets

These budgets document the expenses or costs expected to be incurred by the organisation. Some costs will be directly associated with the earning of revenues (i.e. 'above the line'), while other costs will be incurred in the general operation of the organisation (i.e. 'below the line').

Cost of sales budget (COGS budget)	These are the costs that are directly related to the earning of revenues. In order to determine the cost of sales, you first need to prepare budgets for production requirements – direct labour, as well as purchases of trading stock and raw materials. Revenues less cost of sales tells us our gross profit. These costs are referred to as 'above the line' costs as they appear above the gross profit line.
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Example: Cost of sales budget for a trading organisation

Product	Units	Unit Cost	Cost of Sales
A	6,000	\$75.00	\$450,000
B	33,000	\$39.00	\$1,287,000
C	380,000	\$4.50	\$1,710,000
Total			\$3,447,000

Example: Cost of sales budget for a service organisation

Job	Hours	Approximate Hourly Cost	Cost of Sales
1	4,950	\$59.23	\$293,200
2	3,925	\$59.46	\$233,400
3	7,700	\$61.40	\$472,800
Total	16,575	\$60.30	\$999,400

Operating expense budgets	<p>These are the ‘below the line’ costs that are not directly related to the earning of revenues. They include the</p> <ul style="list-style-type: none"> • Selling/marketing budgets (e.g. advertising costs and sales staff salaries). • Administration budgets (e.g. administration staff salaries and depreciation). • Finance budgets (e.g. interest expense and bank charges).
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Example: Administration expenses budget for a trading organisation

Description	\$
Staff salaries and superannuation	\$32,700
Office supplies	\$3,000
Depreciation	\$5,500
Internet	\$1,000
Telephone	\$625
Rent and rates	\$1,550
Professional services	\$3,200
Postage	\$925
Travel	\$1,325
Insurance	\$900
Motor vehicle	\$1,250
Total	\$51,975

Capital expenditure budgets

These budgets document the larger, longer-term, and often ad hoc or unique expenditures to be incurred by the organisation. They typically relate to capital or infrastructure assets that the organisation will need to invest in to gain or maintain organisational efficiency.



Examples of such items include upgrades to IT platforms, new manufacturing machinery and office fit-outs.

TIP

Example: Capital expenditure budget

Project	Inflow/(Outflow)	Date
Upgrade of IT systems	(\$250,000)	1 July 20X4
Purchase of new office building	(\$485,000)	15 May 20X5
Sale of existing office building	\$795,000	30 June 20X5
Total	\$60,000	

Such expenditures typically cannot be financed solely by the organisation’s operating cash flow, and so external sources of funding are usually required (e.g. bank loans or equity contributions). Note that capital expenditure budgets can also include plans to sell or divest fixed assets, which will lead to cash receipts.