IMPROVING BUDGETING AND FORECASTING EFFECTIVENESS

EXTRACT

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1. INTRODUCTION TO BUDGETING

Budgeting attempts to quantify the future. Firstly, by producing a financial view of expected results. Secondly, by also producing an operational view which involves planning the activities and events that are the drivers of the financial results.

A budget is a financial plan. It is a quantitative statement of the financial consequences associated with an expected or desired level of activity for a specific future time period. The level of activity may be determined in various ways including basing it on one or a combination of the following:

- past events;
- current events; or
- future expectations.

Activity 1.1

What is a forecast and how is it related to budgets?

When you have completed this activity, check your work against the suggested answers at the back of the learning material.

SUGGESTED ANSWERS

Budgets should provide cost estimates associated with revenue forecasts and targets. By forecasting revenue, we are then able to forecast the activity levels required to generate the revenue. By estimating our activity levels, we can then establish the costs of the activities.

Step 1: Forecast the expected level of revenue

↓

Step 2: Generating this revenue will require various activities to be performed

↓

Step 3. These activities will require physical resources in order to perform them

↓

Step 4. These resources will have costs attached, and should also be estimated
Activities are cost drivers and, for budgets to be accurate, a relationship needs to be developed between the activity and the resultant cost. The outputs of these activities are revenue drivers. Important questions we should also be asking include:

- What is a cost – and what types of cost are there?
  - Cost types include: Fixed, step-fixed, variable and semi-variable, direct and indirect, controllable and non-controllable, discretionary and committed.
- How is a cost determined and subsequently managed?
- Does the activity and its cost add value to the organisation?

TIP

Want to know more about costs? CPA has two self-paced learning courses to assist you:

- Cost accounting.
- Value creation through cost control.

Activity 1.2

Hot-desking describes the practice of having no specific desk within an office – you sit wherever you find a seat free. How did the concept of ‘hot desks’ in professional accounting and audit firms come about?

SUGGESTED ANSWERS

When you have completed this activity, check your work against the suggested answers at the back of the learning material.

Activity 1.3

What is the main variable cost for a supermarket retailer like Woolworths Ltd?
Budgets serve a variety of purposes. These include:

<table>
<thead>
<tr>
<th>Planning</th>
<th>to quantify business operations.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Facilitating communication and co-ordination</td>
<td>by linking the management of the different segments of the organisation (e.g. production and sales).</td>
</tr>
<tr>
<td>Allocating resources</td>
<td>when all areas of business compete for scarce resources, and budgets are a method of advising each area what allocations have been made.</td>
</tr>
<tr>
<td>Controlling operations</td>
<td>by providing the basis for financial control by allowing a comparison of actual results against plans, and preparing plans to minimise these discrepancies.</td>
</tr>
<tr>
<td>Performance evaluation and motivation</td>
<td>by providing targets to aim for and incentives for achieving those targets.</td>
</tr>
</tbody>
</table>

**Activity 1.4**

Which of the above purposes do you regard to be the primary function of budgets?

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**1.1 MANAGEMENT CONTROL SYSTEMS**

An organisation’s management control systems provide the foundation for the ‘physical’ aspects of core operating activities and employee behaviour. Budgets contribute towards the organisation’s management control systems through the initial controlling of resources and the subsequent analysis of variances to actual results.

In Figure 1.1 we provide a demonstration of the inter-linkages between the various components of an organisation and where budgeting is positioned.
In this structure, the budgets provide the financial foundations for planning and controlling core activities as well as providing decision making support.

The development of management control systems is closely associated with using organisation structures to improve control and performance. Decentralised organisations are often based on responsibility centres, which are organisational units with a manager who is responsible for its activities. Budgets are required to plan and control these responsibility centres, and the type of budget will depend on the type of centre. Responsibility centres are classified as:

<table>
<thead>
<tr>
<th>Cost centres</th>
<th>Where inputs (costs) are measured in monetary terms, but outputs (i.e. revenues) are not measured or do not exist. There are two main types:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Engineered cost centres;</td>
</tr>
<tr>
<td></td>
<td>Where cost inputs are closely linked to the required outputs being produced (e.g. Production); and</td>
</tr>
<tr>
<td></td>
<td>• Discretionary cost centres;</td>
</tr>
<tr>
<td></td>
<td>Where the expenditure is often not as easily traced to specific outputs (e.g. Accounting, HRM).</td>
</tr>
<tr>
<td>Revenue centres</td>
<td>Where output or revenue is measured in monetary terms, although there is no formal attempt to relate input (i.e. costs and expenses) to output. Sales departments, products and services, regions, customers, and sales personnel are often revenue centres.</td>
</tr>
<tr>
<td>Profit centres</td>
<td>Where managers are responsible for the centre’s revenues and expenses. This may apply to departments, business units, divisions or regions.</td>
</tr>
<tr>
<td>Investment centres</td>
<td>Where managers are responsible for profits (revenues less expenses) and the level of assets invested (investments). These are often subsidiaries.</td>
</tr>
</tbody>
</table>
1.2 FORECASTING AND BUDGETING

There is often confusion between the terms forecasting and budgeting, as they are typically thought to be the same thing. While they are related concepts, there is a difference between the two. The underlying assumptions upon which budgets are based are dependent upon forecasts. The relationship of forecasts to budgets can be summarised as follows:

- Forecasting relates to the analysis of historical operating data and making projections for future levels of activity such as demand for products.
- Budgeting relates to setting target levels of activity, resource allocation and utilisation for the business activities of the firm, based on a forecast of expected business activity.

Hence, forecasts are a necessary information input into a budget model and underpin the assumptions upon which the budget is prepared. For example, where forecasts reveal a reduction in future sales volumes, this will likely lead to a reduction in the organisation’s capacity utilisation. The budget should reflect these changes to capacity utilisation via downsizing or divestment.

1.3 TRADITIONAL APPROACHES TO BUDGETING

Three traditional approaches to budgeting that are used in most organisations are as follows:

<table>
<thead>
<tr>
<th>Method</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Participative budgeting</td>
<td>A process where managers who are held accountable for business performance help develop their own budget estimates.</td>
</tr>
<tr>
<td>Top-down budgeting</td>
<td>The system where senior managers impose budget targets on more junior managers with little or no consultation.</td>
</tr>
<tr>
<td>Bottom-up budgeting</td>
<td>A participative process where employees at the lower managerial levels play an active role in setting their own budgets.</td>
</tr>
</tbody>
</table>

Even though the approach to budgeting may change between organisations, a common requirement is for the budget to be in line with the strategic objectives of the organisation.

Activity 1.5

Are these three approaches to budgeting used in practice? Provide examples of how each of the above methods is implemented and determine whether one method overrides another.

When you have completed this activity, check your work against the suggested answers at the back of the learning material.
1.4 THE BUSINESS/BUDGETING FRAMEWORK

The time frame of the budget, the level of detail, and the impact on operations can vary. For example:

**Revenue or income budgets** based on forecasts of expected business activity classified by:
- day | week | month | quarter | half-year | year | product life cycle;
- product or service;
- customer;
- region; and
- asset or capacity utilisation.

*Operating expenditure budgets* with direct costs and allocated costs associated with revenue streams.

**Cash flow budgets** detailing operating, investing and financing cash flows and running cash balances for the upcoming period(s). These budgets may be prepared showing daily cash balances in difficult times, or may simply summarise each quarter of the year when the cash position is strong.

**Capital budgets** focusing on long-term infrastructure investment over a single- or multiple-year time horizon.

The budgeting process needs to capture the expected resource inflows and outflows. These flows, shown in Figure 1.2, can come from a variety of sources, so this is broader than just focusing on revenues and expenses.

![Figure 1.2: Resource inflows and outflows](image)

We can see that, in addition to revenues, we must also consider inflows relating to equity and debt. We must also be careful to consider the cash flows as well as the accrual based revenue inflows, because timing discrepancies can cause major issues in working capital management.

In terms of outflows, it is important to focus on expenses. However, we must also remember to consider outflows for obtaining non-current assets (capital expenditure), as well as repaying debts and providing for dividends.