CHAPTER 33 - BUDGETS

A budget is simply a financial plan for the forthcoming year, that is drawn up to help a business achieve its objectives.

Budgets are often used to exert a degree of control over the costs of the business, in an attempt to achieve gains in efficiency.

When a business draws up its budget, it is essentially a series of smaller budgets covering all areas of operation. The main budgets that are drawn up are :

A sales budget. This forecasts the number of units of each product that the business aims to sell next year, the price level that will be charged, and the corresponding amount of sales revenue that is likely to be received.
A production budget. This forecasts the number of units of each product that the business aims to produce over the next year. It will include the materials budget, which will indicate the raw materials that need to be purchased.
A staffing budget. This will specify the direct and indirect staff that are required throughout the business for the forthcoming year, in terms of the number of staff and their wages.
A production overhead budget. This attempts to forecast the fixed overheads that the business will incur in the forthcoming year, which can be related to production.
An administrative expenses budget. This forecasts a wide range of expenses for the forthcoming year (e.g. managerial salaries, office expenses, utility bills, and rent or mortgage payments).
A selling expenses budget. This represents the various costs associated with selling the products of the business (e.g. advertising, sales promotions and distribution).
These budgets are then consolidated into the master budget. This also includes several other forecasted documents - specifically, a profit & loss account, a balance sheet, a cash flow and a capital expenditure budget (showing the fixed assets which the business forecasts that it will purchase in the forthcoming year).

It is vital that each department involves all their staff in the planning and budgeting process, firstly in order to identify their needs for the forthcoming year and secondly to act as a motivator, by making the employees feel valued by the business.

It follows on from this, therefore, that each budget that a business sets must be realistic and achievable, since any which cannot be met may leave the workforce with low levels of morale and motivation.

Common mistakes that many businesses make when preparing their budgets for the forthcoming year include:.

Repeating last year's figures.
Each department ignoring the overall objectives of the business, and concentrating instead on their own goals.
Setting unrealistic and unachievable budgets.
Sticking rigidly to the budget, (i.e. forgetting the fact that it is only a plan and a guide for the next year, and consequently it can be changed accordingly).
Variance Analysis

It is vital that a business regularly reviews and revises its budgets. Any discrepancies that exist between the budgeted figures (i.e. for sales, costs, etc) and the actual results are known as variances.

The business needs to investigate these variances and attempt to establish the reasons for their existence - this is known as budgetary control.

Variances can be either positive or negative.

Positive (i.e. favourable) variances occur where the actual amount of money flowing into the business is more than the budgeted figure, or where the actual amount of money flowing out of the business is less than the budgeted figure.

This could be due to a variety of reasons, including an increase in the demand for the products of the business, a reduction in the labour costs, or competitors ceasing to trade.

Negative or adverse (i.e. unfavourable) variances occur where the actual amount of money flowing into the business is less than the budgeted figure, or where the actual amount of money flowing out of the business is more than the budgeted figure.

This could be due to a variety of reasons, including price discounts on the products of the business, an economic recession or a rise in labour costs. For example, consider the following data which has been extracted from the budgeted figures and the actual results for a business :

	Budget	Actual	Variance	
	£ 000	£ 000	£ 000	%
Sales revenue	500	605	105 F	21 F
Raw materials	200	220	20 A	10 A
Labour costs	100	110	10 A	10 A
Advertising	50	45	5 F	10 F
Delivery	20	20	0	0
Utility bills	15	16	1 A	7 A

The business has six budget-heads listed.

It budgeted to have sales revenue of £ 500,000 for the year, but actually managed to sell £ 605,000 of products.

This leaves a variance (the difference between the budgeted sales revenue and the actual sales revenue) of £ 105,000 (or 21% of the budgeted figure). This is a favourable variance (F), because it results in the business receiving more revenue than it budgeted for.

The business budgeted to purchase £ 200,000 of raw materials. It actually spent £ 220,000 on raw materials.

This is a variance of £ 20,000 (or 10% of the budgeted figure). This is an unfavourable or adverse variance (A), because it results in the business spending more money than it budgeted for.

Similarly, the business budgeted to spend £ 100,000 on its labour costs (wages and salaries). It actually spent £ 110,000 on its labour costs.

This is a variance of £ 10,000 (or 10% of the budgeted figure). Again, this is an unfavourable or adverse variance (A), because it results in the business spending more money than it budgeted for.

The business budgeted to spend £ 50,000 on its advertising for the year, but it actually spent only £ 45,000.

This is a favourable variance (F) of £ 5,000 (or 10% of the budgeted figure), since it results in the business spending less money than it budgeted for.

The distribution budget was £ 20,000 and the actual cost of distributing the products was £ 20,000. Therefore there is no variance, since the actual figure was the same as the budgeted figure.

The budgeted figure for the utility bills was £ 15,000. However, the utility bills actually cost £ 16,000. This is an adverse (A) variance of £ 1,000 (or 7% of the budgeted figure), since it results in the business spending more money than it budgeted for.

When investigating and analysing the variances, it is common for managers to concentrate on the large positive and large negative variances and ignore the smaller variances.

This is known as management by exception and involves the managers focussing their attention on those areas which have resulted in large overspending or underspending, and attempting to discover the reasons behind it.

Zero Budgeting

This is where a budget is set to zero for a given time-period, and the manager of the particular division or department then has to justify any expenditure which they wish to make.

It is often used in an economic recession or a downturn in the industry, when money is not as readily available and the business wishes to make cutbacks in its expenditure.

Zero budgeting helps the business to identify those departments which require large amounts of essential capital and day-to-day expenditure, as well as identifying those departments which require minimal expenditure.

However, zero budgeting can result in managers spending far more of their valuable time on the budgeting process than would be the case if budgets were set more traditionally

TOPIC: BUSINESS FAILURE

Business is about risk and reward. The ultimate risk of running a business is that it fails and goes out of existence. Many businesses do fail. Why?

High Failure Rate of New Businesses

The highest rate of business failure is amongst new businesses (start-ups). It should be pretty obvious why this is the case:

Difficult to test a business model without trading
Easy to be over-optimistic in the business plan
Competitor response is often aggressive
Management may lack experience
Among the most common reasons why new businesses fail so frequently are:

No demand for the business idea
Poor market research & unrealistic plan
Competitor response
Just a bad idea – was doomed to fail!
Good idea, but poorly executed
Wrong people; poor management
Growth is too quick (overtrading) or too slow
Failure to manage cash flow
A competitor grabs the good idea and does it better
External shocks
Economic change
Legal & social change

Why Do Established Businesses Fail?

The main reasons why established businesses fail can be grouped into:
FINANCIAL REASONS

- poor management of cash flow
- Inadequate or inappropriate financing.
  NON-FINANCIAL REASONS

- Lack of management control
- Significant external shocks

The key points to remember about each of the four reasons above are:

<u>Evidence of poor management of cash flow:</u>

Significant increases in stock levels

Inadequate credit control
Bad debts incurred
Poor accounting practices including late invoicing
Inaccurate forecasting by management
Failure to plan for significant capital and/or exceptional expenditure

Evidence of inadequate or inappropriate financing:

Use of short term overdrafts for long term investment or capital spending
Failure to use debt factoring when sales are substantially increasing
Inadequate shareholder capital all contribute to cash flow problems
These problems will become more pronounced when a substantial difficulty such as a major bad debt, loss of a major customer or business interruption occurs

Evidence of lack of management control:

Failure to develop a credible business plan
Failure to understand costs, markets and key customers
Failure to administer the business properly
Caught be surprise by significant illegality or unethical behaviour leading to substantial business costs
Excessive marketing expenditure

Evidence of significant external shocks

Loss of important / major customer (particularly if costs cannot be reduced)
Sudden decline in market demand
Change in legislation /government regulations impacting demand or increasing costs
Exchange rate fluctuation
Changes in interest rates
Natural phenomena.