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Drawing up a Budget Checklist 042



Introduction

Budgeting is at the heart of the way organisations measure what they want to achieve. It is a key tool in planning and integrating activities, controlling expenditure, allocating funds, indicating performance against targets, and achieving strategic aims. Modern managers are generally expected to have some financial knowledge and to take some responsibility for financial matters. In real terms, managers rather than accountants make decisions, although the preparation of a budget may need the support of a professional.

Drawing up a budget involves people skills, such as negotiation and listening as well as numerical skills. This should be a dynamic process, which draws managers throughout the organisation into a consideration of their future plans and goals within the wider context of organisational strategy and aims.

This checklist provides a basic introduction to budgeting for managers who may have little financial training, but are responsible for drawing up and presenting a budget for their area. More detail on different types of budgets and differing organisational approaches to budgeting is provided in our related checklist on alternative approaches to budgeting. Advice on controlling a budget is provided in our Checklist on Controlling a Budget (See Additional resources below).

Definition

A budget is a statement of expected expenditure and income that has been allocated under a set of headings, for a set period of time.

The two key purposes of a budget are:

- to demonstrate the financial implications of an organisation's or a department's proposed strategy and plans
- to be used as a basis for control.

Budgets are frequently drawn up annually based on the organisation's strategy and plans for the coming year.

Action checklist

1. Identify the key plans and objectives for the organisation

Key objectives need to be identified so that you are clear about the key priorities which must be considered when preparing your budget. Budgeting is to some extent a secondary process - secondary to the strategic or business plans of the organisation. Only when these are clear can a suitable budget be prepared.

Should it be, for example, a budget for growth or a budget intended to maintain the current position? This will affect the way you draw up the figures.

2. Be aware of organisational policies and procedures

Managers from across the organisation who are involved in budgeting may be formed into a budget committee which:

- establishes procedures and timetables for the development of the budget
- decides general policies affecting the budgets (such as, inflation rates)
- completes budget forms or delegates this within their own sections
- receives and reviews all the budgets as a whole
- suggests revisions
- recommends acceptance of budgets to senior management.

The organisation may also have a budget manual which would typically outline the organisational objectives as they relate to budgeting, specific procedures to be followed in the preparation of the budget, the reporting mechanisms to be adopted and the various budgeting responsibilities across the organisation.

3. Determine the key or limiting factors

Some key factors will limit growth in all organisations. Common examples are: the competitive environment, volume of sales, number of customers and manufacturing plant available. Whatever the key factors are, they will have significance for planning and budgeting. There is no point drawing up a budget based on high volume of sales, for example, if this is either unrealistic or impractical. The preparation of a forecast covering general economic conditions and trends that affect the organisation can be a good starting point for preparing a budget.

Remember that it is difficult to plan long-term in detail because the further you get from the current position, the more likelihood there is of external and internal changes. Thus an annual budget may be more practical than a detailed five-year budget.

4. What is coming in?

Look at the range of income sources - are you generating funds, or is money allocated at the beginning of each year? Will you really get in all the money you have noted down, or will some come in the next financial year, or fail to materialise? How much of this is guaranteed income? What financing options are available to you? Will the organisation be relying on debt or equity financing, or a combination of these?

5. What is going out?

Estimate your expected costs and break them down under different headings. The range of cost headings usually include those related to:

- staffing, - e.g., wages, pensions, training
- premises – e.g., rent, repairs, heating
- a company's legal duties
- materials used –e.g., stationery, telephone, raw materials
- any other business costs – e.g., financing, insurance, company tax, subscriptions.

The general principle is to divide the budget up under whatever headings seem sensible to you - but, as organisations often group headings together, ensure that there is a reasonable degree of consistency across the company. Look at the headings used in the previous year and use them as a starting point.

6. Think through the fixed and variable costs

There are two types of costs:

- fixed costs - those costs that will need to be met no matter how much extra work the organisation handles, permanent staff costs, for example.

- variable costs - costs that are dependent on the organisation's level of work, such as the quantities of raw material purchased or the amount of advertising that is undertaken.

Your finance department should be able to help you to identify your fixed and variable costs.

7. Decide how to draw up the budget

There are different approaches to drawing up a budget. Whichever method is used, the budget should be prepared in the same format that will be used for reporting in the upcoming period. In addition, an underlying list of assumptions should be prepared and documented as part of the budget process, as this makes it easier to explain variances in due course.

Incremental budgeting is based on using last year's figures. If you use this method you would base a budget on how last year's went - with, of course, an adjustment to take inflation into account. This is a quick and simple way of putting a first draft of a budget together. Its main drawback is that, if last year's budget was wrong, you keep adding to your mistakes. It is also a conservative approach, based on the assumption that there is a high degree of continuity and that current objectives will not change.. This process is unlikely to lead to any step changes the organisation might consider to improve existing and future performance.

If you are using an incremental approach, work out how far last year's budget actually reflected reality. Write down:

- the budget
- the way it actually worked - what you actually spent
- the variance - how far was the budget out, and why.

Zero-based budgeting starts from scratch and considers each cost from the start of each year. Analyse each cost according to how the picture looks now rather than referring back to the previous year's budget. This is a fundamental approach, which requires objectives to be redefined and every item to be justified.

8. Collect all the information you need to set this year's budget

Make sure you speak to all stakeholders before drawing up the budget, to ensure that they have had an opportunity to provide input and that nothing has been missed.

Review the organisation's objectives and targets to see if, and how, your budget needs to be adjusted or reconstructed. Remember that the budget will be a key element in assessing performance. It must therefore be structured so as to allow regular monitoring against organisational or departmental targets.

Assess all external and internal factors that may have a bearing on performance. These may include the rate of inflation, bank lending rates, trade prospects forecast for the following year, and whether you wish to stimulate the market (and therefore need to budget for the resources - money, people and equipment - to do so). Budgeting for growth also means having resources available to handle the hoped-for increase in levels of business, so take care not to stimulate a demand you cannot meet.

When drawing up a departmental budget keep relationships with other departments in mind. For example it is unrealistic to set the manufacturing budget before a sales budget has been at least drafted. If you are setting a budget for maintenance, forecasts of levels of factory activity need to be consulted. Such dependencies may be co-ordinated at a more senior level, or by the finance department. Budgeting is likely to be an iterative process.

9. Ask some important questions

The following questions will assist you in preparing a more accurate budget.

- Am I clear about strategic objectives and how they affect my area of responsibility?
- Have I accurately forecast the number of people required to meet objectives?
- Are there likely to be any changes?
- Am I clear about the income?
- Am I clear about outgoings?

- Are there any factors on the horizon that might have serious implications for the budget?

10. Draw up the budget

Keep detailed notes on why particular figures have been recorded in your budget. This may seem obvious when you write the figures down, but if you are asked to discuss them in six months' time, you may not remember how you calculated them. Build in a contingency allowance, just in case things go wrong, either through setting revenue targets below those forecast, in case levels of business do not meet expectations; or by controlling expenditure early in the financial year, until you get a clearer picture of how well you are performing to budget. If there is great uncertainty about outcomes, consider including a "high/low" range for your key forecasts.

11. Build in budget control parameters

You or your finance department will need to track income and expenditure against the budget. This may be monthly, weekly or even daily, depending on the nature of the business. (See Checklist 043 on Controlling a Budget.)

12. Present the budget

If you are required to make a presentation on the budget to senior managers or colleagues in addition to producing a written statement, make sure that you give a realistic picture (including possible down-turns and problems) rather than just attempting to impress. If the budget looks optimistic or pessimistic, say so and explain why. Before presenting the budget ensure you have "buy in" from key contributors.

Managers should avoid:

- drawing up a budget without involving others
- failing to evaluate their assumptions
- being over-optimistic
- simply applying percentage changes to the previous budget without good justification
- collecting too little information on which to base the budget.

National Occupational Standards for Management and Leadership

This checklist has relevance to the following standards:
Unit EA4 Manage budgets

Additional resources

Books

Pathways Financial management unit 7003 V1: level 7 strategic management and leadership
(CMI Pathways Plus strategic management and leadership series)
Corby: Chartered Management Institute, 2013

Brilliant budgets and forecasts: your practical guide to preparing and presenting financial information, Malcolm Secrett
Harlow: Pearson Education, 2010
This book is available as an [e-book](#).

Managing resources, Bernice Walmsley
(Instant Manager series)
London: Hodder Education, 2010
Preparing and managing a budget is covered in chapter two.

Accounting in a nutshell: accounting for the non-specialist, 3rd ed., Janet Walker
Oxford: CIMA Publishing, 2009
Budgetary planning and control is covered in Chapter 11

Get to grips with budgets: how to take the stress out of working with numbers
London: Bloomsbury, 2005

Better budgeting: a report on the better budgeting forum from CIMA and ICAEW
London: Chartered Institute of Management Accountants and Institute of Chartered Accountants in England and Wales, 2004

This is a selection of books available for loan to members from CMI's library. More information at:
www.managers.org.uk/library

Journal Articles

Just in time budgeting for a volatile economy, Mahmut Akten, Massiom Giordano and Mari A Scheiffele
McKinsey Quarterly, no 3, 2009, pp 115-121

Integrating strategic management and budgeting, Tim Blumentritt
Journal of Business Strategy, vol 27 no 6, 2006, pp 73-79

Related checklist

Controlling a budget (043)
Alternative approaches to budgeting (247)

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Controlling a Budget Checklist 043



Introduction

Budgetary control is at the heart of many managers' jobs. The skills of budgetary control are increasingly valued in organisations, and the ability to control a budget is considered an important attribute for managers.

A sound system of budgetary control can provide a firm foundation for sound business management. The primary objective of budgetary control is profitable spending for desired results, indicating what is required in order to maximise the profits made or the service supplied by the organisation and to manage the finances efficiently. Budgetary control works best when a company has a formalised reporting system. This should include analysis of what happened when plans came to be put into practice, and what the organisation did or did not do to correct for any variations from the plans.

The manager's role involves ensuring that budgetary policies and decisions that have been made are implemented, that as far as possible budgets which have been set for a manager's area of responsibility are adhered to and that any problems are identified and addressed in good time. This will help managers to monitor organisational and team performance, give them a clear idea of their department's financial position and provide information on which to base future actions. The mix of skills required for controlling budgets includes: gathering and using information; setting up early warning systems; taking decisions and monitoring results.

Budgets are expectations of performance in financial terms which help managers to achieve financial targets. The master budget is a group of budgets required to run an enterprise. Examples of types of budgets set up by executives or business owners and controlled by managers are:

- income/revenue budgets
- expense budgets
- profit and loss budgets
- cash budgets
- project budgets
- capital expenditure budgets
- fixed and flexible budgets.

This checklist provides guidance for all managers with budgetary responsibilities.

Definition

Budgetary control is the process of comparing actual costs, revenues and outcomes with those forecast in the budget set, and the initiation or authorisation of any corrective action required to stay on budget.

Action checklist

1. Understand the figures

Make sure that you understand how the figures in the budget are made up. You need to be clear about which figures you control and will be held responsible for, and which lie outside of your control. For instance, if staff costs are higher because you sanctioned too much overtime, you may be held responsible for the resulting budget over-run; but if staff costs are higher because a pay rise was higher than expected, you are unlikely to be held responsible for the over-run or to have any control over it.

The minimum information requirements are:

- a) types and amounts of authorised expenditures
- b) purposes for which expenditures are to be made
- c) planned means of financing expenditures.

Business managers should familiarise themselves with the chart of accounts and main accounting terms and ratios including revenue, turnover, cost of sales, direct costs, indirect costs, overheads, fixed costs, semi-variable costs, variable costs, break-even point, profit mark-up, gross profit percentage, stock: turnover ratio, return of capital employed, interest rates, retail price index and consumer confidence index. The exercise of effective control of income, expenses, profit and assets is assisted by expressing figures as ratios and percentages.

2. Communicate with your accounts department

Find out what reports your accounts department can produce for you. This will save you work, give you accurate figures and help you to keep in touch with accounts personnel - this is important because they are usually key organisational stakeholders. Accounts departments typically produce updated charts of accounts and monthly management accounting reports including analysis of sales and expenses under different cost centre and department headings, profit and loss accounts, cash flow statements, analysis of budget variances and projected management accounts for the year ahead.

3. Set up an early warning system

A monitoring and early-warning system will help keep track of costs and income. Control procedures must be tailored to suit the needs of the individual organisation, and should be flexible and economical to operate. The key consideration is to have a cost-effective budgetary control system that provides "the right information to the right people at the right time".

A paper system which keeps a tally of the costs incurred and checks them at the end of the month can work well for small budgets. Larger ones require the use of suitable software and information systems, and even small budgets will benefit from the use of simple spreadsheets.

Financial figures will often be presented with a lot of detail. To make it easier for people to make practical sense of these, most organisations have adopted the exception principle, whereby only exceptions to the norm that are significant are notified. These are generally areas where there will be a need for decisions to be taken.

4. Decide on the appropriate time to monitor your budget

Monitoring the budget is a key factor in controlling costs and borrowing. Information supplied soon after the event will be of most assistance. As the time-lag after the end of a costing period increases, so the utility of that information is decreased.

Choose a review period which fits in with the other commitments affecting your organisation or team, such as:

- weekly
- monthly
- quarterly

It is important to get the time-scale right: if you over-monitor, you waste time; but if you under-monitor, you won't be able to stay in control. The frequency you set will also be influenced by the financial state of the business. If it is under-performing, reviews are likely to be more frequent than if income is above target. It may also be helpful to take account of the annual spending cycle, restricting expenditure at the start of the year to allow for eventualities later, but permitting additional productive expenditure later in the year, if there is money in hand, for example.

The table below shows generally recommended frequencies in a manufacturing business:

Name of Report	Frequency	Purpose	Primary Recipients
Sales / revenue	Weekly	Determine whether sales/revenue goals are being met	Top management and sales manager
Labour	Weekly	Control direct and indirect labour costs	Production director and production department managers
Stock / purchases	Daily	Determine efficient use of materials	Production manager
Departmental overheads	Monthly	Control overhead costs	Department manager
Selling expenses	Monthly	Control selling expense	Sales manager
Management accounts	Monthly and quarterly	Determine whether income, profit and investments objectives are being met	Top management
Cash flow statement	Weekly	Control borrowings and determine efficiency of cash management	Top management and financial controller
Debtors aged list	Weekly	Credit control and monitor budgeted limits of accounts	Top management, financial controller and sales manager
Creditors aged list	Monthly	Control borrowings and monitor budgeted limits of accounts	Top management, financial controller and purchasing controller

5. Identify variances

Use the information that you collect to identify variances from your original budget - both positive and negative. A negative variance indicates that you have spent more than you planned - so you will need to look hard at the reasons for this and the effect it will have on the year's performance, and review your plans. A positive variance indicates you have under-spent.

6. Don't assume a positive variance is a good thing

Analyse all variances, positive and negative. Find out why it is happening and what effect it will have on the year's activity. Is it due to a one-off payment that has not been invoiced (that is, a blip rather than a trend)? Has it been caused by an unexpected drop in interest rates (and is this likely to continue)? Are sales of a particular product or service in decline? Have you failed to carry out planned marketing activities? Have you been unable to recruit a key member of staff?

7. Tell the right people

If you find you have a problem, make sure that this information is passed to the right people so that appropriate action can be taken. For instance you may need to talk to:

- your boss or line manager
- your company accountant
- your team members.

People often won't be aware of problems unless you tell them, and no action can be taken until everyone who needs to know has been informed. But remember, the communication process is two-way, and your team members may also be able to provide early warnings of problems. Discuss budget variances with your team to discover what they know about why these have arisen. Working on the front line, they may have up-to-the-minute information on why and how things are going wrong.

8. Now take action

Ensure that all budget holders are provided with regular monitoring reports. Take account of what information is needed by different audiences and the level of financial understanding they possess. Make sure that your monitoring reports show actual and/or committed expenditure and income to date, variance against budget, and projected out-turn. Ensure that reports are made available within a time period that allows effective corrective action to be taken where necessary (e.g. within 4 weeks of the end of a month).

There are a range of options you might take at the end of the monitoring process, depending on the circumstances:

- do nothing if you anticipate that the budget will shortly come back into line - but make sure you can prove that this expectation is well-founded, and review your monitoring period so that you will be able to check that your predictions are realised
- prepare a forecast (or revise your existing one) of where you expect to be, compared to budget
- suggest corrective action to bring income and expenditure back into line with the original budget. For instance, cut back on costs, take action to increase sales, or put in a bid for under-spends elsewhere.

Once you have decided what action to take, make sure that all the right people know, understand and, if necessary, have had time to comment on your plans. Then, be seen to act decisively!

9. Keep monitoring the budget

Monitoring is an on-going process. Don't assume that, because you've put one problem right, there will never be another. Keep monitoring the budget to make sure it stays in line, or doesn't get further out of control.

Ensure that budget monitoring results in regular feed back into corporate and departmental policy and planning to ensure that policy objectives are being attained. Ideally, you should constantly monitor to develop the master budget plan and not limit yourself to looking only at the operational plan. You should also control the following in a financial plan which makes up a master budget:

- a) budgeted retained earnings
- b) budgeted capital expenditures
- c) change in fixed assets
- d) budgeted balance sheet
- e) cash flow statements.

In today's volatile economic conditions, frequent monitoring is particularly important. Uncertainty and complexity are leading to a growing trend towards real time budgetary monitoring, especially for vital indicators of the financial health of the business. Larger companies are also using integrated Enterprise Resource Planning (ERP) systems to provide budgetary data for analysis.

10. Communicate any changes

When forecasts have to be changes, make sure that all budget stakeholders are informed - especially if they will need to implement related changes. You should also keep abreast of changes in the ongoing budgetary planning process.

Managers should avoid:

- acting rashly, without thinking through all the implications
- failing to involve others in decision making
- ignoring or concealing any problems – they won't go away
- entrusting budgetary responsibilities to colleagues who do not have adequate financial training and the skills needed to manage budgets.

National Occupational Standards for Management and Leadership

This checklist has relevance to the following standards:
Unit EA4 Manage budgets

Additional resources

Books

Brilliant budgets and forecasts: your practical guide to preparing and presenting financial information, Malcom Secrett (See especially Chapter 9 Allocation, Reviewing and Monitoring)
London: Pearson Education UK, 2010
This book is available as an [e-book](#)

Financial management, E Learn
Oxford: Taylor & Francis, 2008
This book is available as an [e-book](#).

Get to grips with budgets: how to take the stress out of working with numbers
London: Bloomsbury, 2005

Budgeting for non financial managers: how to master and maintain effective budgets, Iain Maitland
London: Prentice Hall, 2000

Managing budgets, Stephen Brookson
London: Dorling Kindersley, 2000

This is a selection of books available for loan to members from CMI's library. More information at:
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Journal Article

Just in time budgeting for a volatile economy, Mahmut, Massimo Giordano and Mari A Scheiffele
McKinsey Quarterly, no 3, 2009

Related checklists and models

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Alternative approaches to budgeting (247)

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Cash Flow for the Small Business Checklist 120



Introduction

Cash flow is often referred to as the lifeblood of an organisation. With it, operations can proceed smoothly, allowing the best decisions possible to be made and without concerns about the company's ability to pay. Without it, decisions are often hampered by the inability to pay and thus a company can end up implementing a plan or taking a course of action that is not in its best interests. This checklist is designed to help you develop an understanding and control of cash flow in your business.

Controlling cash flow will mean that you know where your cash is tied up, you will be able to spot potential bottlenecks and act to reduce their impact, and you will be able to reduce your dependence on bankers which will result in savings on interest charges. Most importantly, you will have control of your business and will therefore be able to make informed decisions.

It is important for cash to flow effectively through the system, as illustrated in the diagram below. Too little cash, or indeed any factors impeding a smooth and continuous flow of cash, create problems. Without an adequate flow of cash, a company may be trading profitably in the shorter term, but may nevertheless collapse. Poor management of cash flow is said to be the most common reason for the failure of small firms.

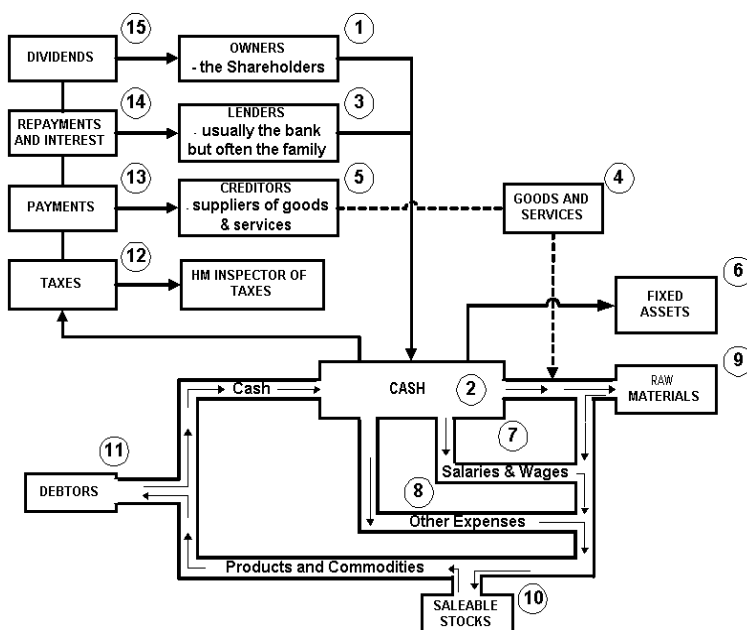


Fig. 1

Figure 1 illustrates the flow of cash through a business. The flow starts at (1) when the would-be owners of the business (or shareholder(s) if it is to be a limited company) invest funds, which go into the pool of cash (2).

This investment may not be a once and for all step. There may be subsequent investments for a variety of reasons, some of which could well be positive – for example, business expansion. Others may be negative, such as a shortage of liquid funds. At the same time, or again later, lenders (3) may also put funds into the cash pool. The lenders may be the firm's bankers or, in some cases, members of the family or friends of the owners of the business.

To enable the firm to start trading we will assume that it obtains goods and services (4) on credit from suppliers (5) who become creditors. Consideration will be given to obtaining fixed assets (6). These may range from freehold buildings to office equipment. You will recognise that if acquisition is based on purchase, and if relevant assets are truly fixed, some liquid capital has been immobilised immediately. Cash also flows out of the 'pool' in the form of salaries and wages (7) and other expenses (8), which may include, for example, stationery and additional computer software.

If the new firm is to manufacture, it will require raw materials (9) - another outflow of cash (sooner, if the materials are paid for immediately, and not very much later if they are purchased on credit). The expenditure on wages and other expenses (for example tools), together with the use of some of the raw materials (7), (8) and (9), will lead to the creation of saleable stocks (10). If the firm does not manufacture products for sale, it will purchase saleable stocks for resale. The stocks will join 'the stream' on their sale and will probably be sold on credit to customers who become debtors (11). They will owe the firm the price of goods or services supplied until they pay. When they do pay, cash will continue to flow back into the cash pool (2).

Yet the cycle is still not complete. At the appropriate time, cash will be moved from the pool to pay taxes (12), to make payments to creditors (13), to make repayments of capital and payments of interest to lenders (14) and to make payments of dividends or other forms of reward to the owners, the original investors (15). The flow of cash through the business is never ending. If there is a blockage at any point, e.g. if sufficient money to purchase raw materials is unavailable - it may be difficult for the company to continue operating, even when the business is healthy in every other regard. Without an injection of cash, trading will cease and the firm will be wound up.

Definition

In accounting, cash flow refers to the amounts of cash being received and spent by a business during a defined period of time, sometimes tied to a specific project. Measurement of cash flow can be used to evaluate the state or performance of a business or project.

Action checklist

1. Identify the potential cash bottlenecks through your firm

A careful examination of Fig. 1 may suggest bottlenecks at these points:

- fixed assets (6)
- raw materials (9)
- saleable stocks (10)
- debtors (11).

Examine these bottlenecks in turn, and consider how you would deal with any issues that may arise as a result of these bottlenecks.

2. Reconsider your investment in fixed assets

- Is cash unnecessarily tied up in fixed assets?
- Is it tied up in assets which are not used or could be disposed of?
- Is it tied up in necessary assets which could be replaced by leasing?

- Is it tied up in assets which represent a greater than necessary investment which could be replaced by something more modest?
- Has cash been invested in fixed assets for reasons of prestige rather than of profit?

3. Reconsider your investment in raw materials

- Have you tied up cash in raw materials to take advantage of special terms offered by suppliers?
- Do you have an efficient supply chain?
- Are you sure that the advantages outweigh the costs of holding stocks which may not be used immediately?

The advantages must be weighed against the following factors:

- the cost of borrowing money to finance stockholding
- the loss of alternative uses for the capital employed
- the costs of physical storage
- risks of stock shrinkage.

Likewise reconsider your investment in saleable stocks.

4. Reconsider your system of stock control

An appropriate system of stock control does not necessarily presuppose precise stock records for every line held in stock. The type of records adopted will depend on common sense. The cost of the system must be weighed against a financial evaluation of the problems which the system is intended to help solve.

Some form of control is necessary to guard against theft, obsolescence, spoilage, running out or having too much or an unbalanced stock, any of which can penalise a business severely. The basic requirements of a stock control system may be summarised as:

- a forecast of what you expect to sell and when
- a knowledge of your present stocks, provided at regular intervals
- a record of supplies received and deliveries made which should be periodically reconciled with present stocks (this reconciliation need not be of everything but only of selected items in sequence)
- predetermined and regularly reviewed re-order levels and quantities
- a knowledge of price trends, quantity discounts and the time which will elapse from the placing of an order until delivery.

Check stock at least once a year. Have you considered a perpetual inventory system or a cyclical stocktaking procedure using employees as and when fluctuating workloads make this possible? Are your stocks neatly stored in a way that makes stocktaking easy and eliminates the risk of contamination, obsolescence and damage?

5. Look carefully at your systems for granting and controlling credit

There is a direct relationship between the amount and length of credit allowed and the return on capital and net profit which a firm can make. It is assumed that in most cases it is more important to obtain the quickest possible turnover of capital rather than producing an additional return on capital 'lent' to a customer. Make sure your method:

- recovers the cost of extending credit
- gives the customer the greatest continuing incentive to pay promptly.

6. Consider carefully the following self-testing questions on credit management

You may wish to consider these points in order to manage credit in your business more effectively, therefore allowing cash to flow more freely:

Policy

- Is there one person in your firm who is ultimately responsible for supervising credit and for ensuring the prompt collection of monies due and who is accountable if the credit position gets out of hand? The exercise of their authority should not detract from the individual salesperson's relationship with the customer - nor from the individual salesperson's responsibility for seeing that the sales which they make are paid for in accordance with the firm's credit terms.
- Do you have a clear-cut maximum credit policy? Is it written down? Is it known to all your sales team? Are they instructed to ensure that all your customers are familiar with your policy?
- Are you clear in your own mind as to how you assess credit risks and how you are to impose normal limits - both in terms of total indebtedness for each customer's open account (including cheques in course of collection) and also in terms of time?

Bad debts

- Do you recognise that - assuming you make 1.5 per cent net sales - a loss of £1,500 in bad debts nullifies the net profit on £100,000 sales and destroys all the effort involved in making those sales?
- Do you recognise that an avoidable loss of £1,500 in bad debts means that a lot of abortive effort will have been expended in trying to collect this money before it is written off - and that the cost of this effort is probably 'hidden' and never identified?
- Do you recognise on the other hand that the absence of any doubtful - as opposed to bad - debts probably means that you have been missing out on business by being 'overcautious'?

Granting or extending credit

- Do you methodically check the financial standing of all new customers before executing the first order?
- Do you re-check the financial standing of existing customers whose purchases have recently shown a substantial increase?
- Do you use the telephone when checking trade references? Suppliers will often tell you over the telephone what they would not put in writing.
- Do you recognise that sales people are by nature optimists? Do you therefore rely on other sources of information before establishing (or increasing) credit facilities for customers?

Credit control and collection

- How soon do your invoices go out after the goods are dispatched? Can this be speeded up?
- How soon do monthly statements go out following the last day of the month? Can this be speeded up?
- Are the terms of sale clearly and precisely shown on all quotations, price lists, invoices and statements?
- What is the actual average length of credit you are giving - or your customers are taking? What length of credit do you allow?
- Do you prepare monthly lists of all customers whose settlement is overdue and do you list the total indebtedness of slow customers as well as the overdue amount? If their slow paying habits reflect financial difficulties, the whole debt may be at risk.
- Do you have a collection procedure timetable? Do you stick to it?
- Are you politely firm but insistent in your collection routine?
- Do you watch the ratio of total debt on balances on the Sales Ledger at the end of each month in relation to the sales of the immediately preceding twelve months? Is the position improving, deteriorating, or static? Why?
- Do your salespeople recognise that 'It's not sold until it's paid for'? Could you consider linking part of the salesperson's commission to receipt of payments from your customer?
- Have you considered offering an early settlement discount to your customers to encourage them to pay early? This could boost cash flow for a relatively low cost.
- If experiencing cash flow difficulties have you considered redeploying staff from sales to work on credit control?

Paying your suppliers

- Have you negotiated the best possible payment terms with your suppliers? Extending the time you have to pay is another way of easing cash flow concerns.
- Will your suppliers consider extending a credit facility to you rather than you having to pay for goods on order or delivery?

Managers should avoid

- assuming that all sales are equal
- disregarding the customer service department which can enhance cash flow
- mismanaging quality control.

National Occupational Standards for Management and Leadership

This checklist has relevance to the following standards:
E: Using resources, unit 2

Additional resources

Books

Finance for non-financial managers, Clive Marsh
London: Kogan Page, 2012

Finance for non-financial managers, Philip Ramsden
London: Hodder, 2010

Cash management on a shoestring, Tony Dalton
London: A and C Black, 2007

How to manage profit and cashflow: mining the numbers for gold, John A Tracy and Tage C Tracy
Hoboken NJ: John Wiley, 2004

Essentials of cash flow, H. A. Schaeffer
Hoboken NJ: John Wiley, 2002

This is a selection of books available for loan to members from CMI's library. More information at:
www.managers.org.uk/library

Related checklists

Controlling a budget (043)
Controlling costs (126)
Controlling credit (127)
Reading a profit and loss statement (183)
Discounted cash flow (185)

Internet resources

Business Link: www.businesslink.gov.uk

Under "finance and grants" in the menu at the top left of the home page, there are sections on cash flow. Has a section 'Cashflow management: the basics', interactive tools to assess how your business is performing and other resources.

Organisations

Institute of Chartered Accountants in England and Wales (ICAEW)

Chartered Accountants' Hall, Moorgate Place, London, EC2R 6EA

Tel: 020 7920 8100 Web: www.icaew.co.uk

The Institute of Chartered Accountants of Scotland (ICAS)

Chartered Accountants House, 21 Haymarket Yards, Edinburgh, EH12 5BH

Tel: 0131 347 0100 Web: www.icas.org.uk

Chartered Institute of Management Accountants (CIMA)

26 Chapter Street, London, SW1P 4NP

Tel: 020 8849 2251 Web: www.cimaglobal.com

Chartered Banker Institute

38b Drumsheugh Gardens, Edinburgh, EH3 7SW

Tel: 0131 473 7777 Web: www.charteredbanker.com

This is one of many checklists available to all CMI members. For more information please contact

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Chartered Management Institute

Management House, Cottingham Road, Corby NN17 1TT.

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Revised June 2012

Managing Working Capital Checklist 182



Introduction

Effective management of working capital is sometimes overlooked as a critical success factor by companies struggling for competitive advantage amid fierce competition. Capital that is unnecessarily locked up weighs performance down rather than being available for investment and value creation for shareholders.

For most businesses, the control of working capital is fundamental to their finances, and good working capital management can improve their cash position – particularly in an economic downturn, where other forms of credit are not readily available. Working capital management involves the control of stock, debtors and creditors and may involve a number of employees in the process.

Implementing good working capital management will help to earn interest or reduce interest payments and it will assist in producing a realistic annual budget. Good working capital management will also help managers to take financial responsibility, think about the future and plan accordingly, measure their own performance and the performance of their team, and will assist managers in different parts of the organisation in coordinating their activities.

Definition

The term "working capital" refers to the current assets of the firm, i.e. cash, and those items that can be converted into cash within the next 12 months, such as stock and work-in-progress, and sums owed by debtors.

Net working capital is defined as the difference between current assets and current liabilities. Current liabilities consist of amounts that are owed by the firm that will be paid within 12 months. The major proportion of current liabilities is often, but not always, owed to trade creditors, i.e. amounts owed to suppliers and accrued expenses.

Action checklist

1. Establish systems to measure working capital

Ensure that levels of working capital can be measured accurately and regularly, ideally on a daily basis, and certainly on a weekly basis. Establish systems that will allow you to state the amount of cash, debts, stock, work-in-progress, and sums owed to creditors.

2. Record past and current levels of working capital

Knowing your current and past levels of working capital is a useful starting point. This helps with setting a realistic budget and will enable you to establish times of the month/year when elements of working capital are normally higher or lower. For example, some businesses will hold higher levels of stock as Christmas approaches.

3. Benchmark your levels of working capital

Although it can prove difficult, it's very useful if you can compare your levels of working capital with similar organisations. You may also find it helpful to benchmark with companies outside your sector in order to raise your own levels of working capital above the industry norm. Some organisations may be willing to share information with you on a regular basis. At the very least you may be able to obtain their annual financial accounts and calculate useful ratios:

- **Stock turnover** is the rate at which stock moves through an organisation. This is calculated by dividing the cost of sales by the average stock. For example, if the material cost of your sales was £500,000 and your average stock was worth £300,000 in a given year:

$$\frac{£500,000}{£300,000} = 1.66 \text{ times per annum}$$

A higher score indicates that stock is lower and therefore less capital is tied up. This is generally better for business although there are all sorts of variables which affect the optimal amount of stock turnover. Therefore, you will need to consider what the best level of stock turnover is for your industry or type of business.

- **Debtor days ratio** shows how long, on average, your customers are taking to pay for goods. For example, your customers owe you £14,000 on a given date. Your annual turnover is £100,000. Multiply the amount owed by the days in the year, 365, and divide the result by the annual turnover, £100,000:

$$\frac{ (£14,000 \times 365) }{ £100,000 } = 51 \text{ days}$$

So each customer is taking 51 days, on average, to pay. Remember this calculation can be distorted if your business is very seasonal, so it works best if your invoices are spread evenly throughout the year. A lower figure is better as cash is being received faster from customers.

- **Creditor days ratio** shows how long, on average you are taking to pay your suppliers. For example, you owe your suppliers £9,000 on a given date, and across the year you pay out £150,000. Multiply £9,000 by the days in the year, 365, and divide the result by the total amount you pay:

$$\frac{ (£9,000 \times 365) }{ £150,000 } = 22 \text{ days}$$

Suppliers are, on average, being paid in 22 days. Again, seasonal differences can influence the results so this calculation works best when your purchases are made evenly during the year. A higher figure is better as cash remains in the organisation for longer. Delayed payments could cause cash flow problems particularly to small businesses. However, there is also legislation in place that gives small businesses the right to charge interest for late payments.

4. Look for improvements

There are a number of ways in which lower stocks and sums owed by debtors, and higher sums owed to creditors, can be achieved:

a) stock and work-in-progress

- forecast sales accurately
- improve stock control systems to identify over- or under-stocking
- where appropriate, get suppliers onto a "Just-in-Time" system (where, in effect, they hold the stock for you)
- minimise your holdings of finished goods by accelerating the dispatch process
- eliminate slow moving lines
- where appropriate, hold one central store, rather than several.

b) debtors:

- agree trade terms with customers
- carry out checks to verify that prospective customers can pay
- establish an effective credit control system with a sensible collection policy
- ensure that statements and invoices are issued correctly and promptly
- offer early payment discounts and charge interest on overdue debts
- follow up late invoices in person
- resolve disputed invoices quickly
- pay commission to sales people on receipt of cash from customers, rather than when the sale is agreed/invoiced.

c) creditors

- agree trade terms with suppliers or lenders, e.g. banks
- delay payment to suppliers until the last day of trade terms
- calculate whether it is worth paying suppliers early in order to qualify for discounts.

d) cash

- predict cash surpluses and make investment plans
- predict cash shortages and make prior arrangements with banks and other lenders
- ensure that you borrow from the cheapest source, but be aware of penalties for late payment
- deposit cash at the bank every day if practicable.

It is very likely that some improvements will lead to other costs being added elsewhere – for example, the frequent deliveries that accompany a just-in-time system may add more transport costs than is saved via holding less stock. Therefore, careful thought on the consequences of any changes is required, in order to make beneficial trade-off decisions.

5. Set targets and incentives

Targets and incentives can be set in each of the areas above. For example, a bonus could be paid for the achievement of a lower debtor days figure. Any incentives should not just be limited to your finance department. For example, your sales force is key here – if they are rewarded for growth alone, they may focus on the initial sale at the expense of getting a timely payment.

6. Establish and monitor cash and working capital budgets

You may need the help of an accountant to establish realistic cash and working capital budgets. These should give predictions for the levels of cash, stock, debtors and creditors on a weekly or monthly basis.

Regularly compare actual performance against budget and take appropriate action. For instance, if stock levels are higher than budget you may need to review the lists of slow moving products lines and possibly discontinue some of them.

7. Foster a culture of value

Whilst it is unlikely that everyone in your organisation will have a high level of knowledge of working capital, key people operating at all levels throughout the company should have some awareness of it and be prepared to contribute to improving the management of working capital. If key performance indicators are devised which drive working capital performance, this enables directors to stay in the picture. At a more junior level, promote awareness of the concept of working capital, and encourage employees to make suggestions and improvements.

Effective working capital management is an important driver of a company's profitability, so it is in the interest of all employees that it is done well.

Managers should avoid

- being over-optimistic
- leaving too little time for planning
- drawing up a working capital plan without involving key people, including, for example, your bank manager.

National Occupational Standards for Management and Leadership

This checklist has relevance to the following standard:
LE Manage the use of financial resources, unit A3

Additional resources

Books

Financial management for non-financial managers, Clive Marsh
London: Kogan Page, 2012

Guide to cash management, John Tennent
London: The Economist in association with Profile Books, 2012

Guide to business modelling, 3rd ed., John Tennent and Graham Friend
London: The Economist in association with Profile Books, 2011

Mastering financial management, Clive Marsh
Harlow: Financial Times Prentice Hall, 2009

Finance on a beermat, Mike Southon, Chris West, Stephen King and Jeff Macklin
London: Random House, 2006

This is a selection of books available for loan to members from CMI's library. More information at:
www.managers.org.uk/library

Journal articles

Capital is king, John Mullins
Business Strategy Review, Winter vol 20 no 4 2009, pp. 5-8

Need cash? Look inside your company, Kevin Kaiser and S. David Young
Harvard Business Review, vol 87 no 5 May 2009, pp. 64-71

This is a selection of journal articles available from CMI's library. More information at
www.managers.org.uk/library.

Related checklists

Controlling a budget (043)
Controlling costs (126)
Controlling credit (127)
Reading a profit and loss statement (183)

Organisations

Institute of Chartered Accountants in England and Wales (ICAEW)

Chartered Accountants' Hall, Moorgate Place, London, EC2R 6EA

Tel: 020 7920 8100 Web: www.icaew.co.uk

Institute of Chartered Accountants of Scotland (ICAS)

Head Office, CA House, 21 Haymarket Yards, Edinburgh, EH12 5BH

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Revised April 2013

Alternative Approaches to Budgeting Checklist 247



Introduction

Budgeting is an important tool for management control and an aid to strategic financial management. This checklist explains the foundations to sound budgeting and considers how budgets support and refine plans. The major types of budgets and approaches to budgeting are also outlined.

The checklist aims to provide an understanding of:

- how budgets are prepared from plans and also influence plans
- how performance against budgets is monitored
- the principal types of budget and some alternative approaches to budgeting
- which type of budgeting is appropriate for your business.

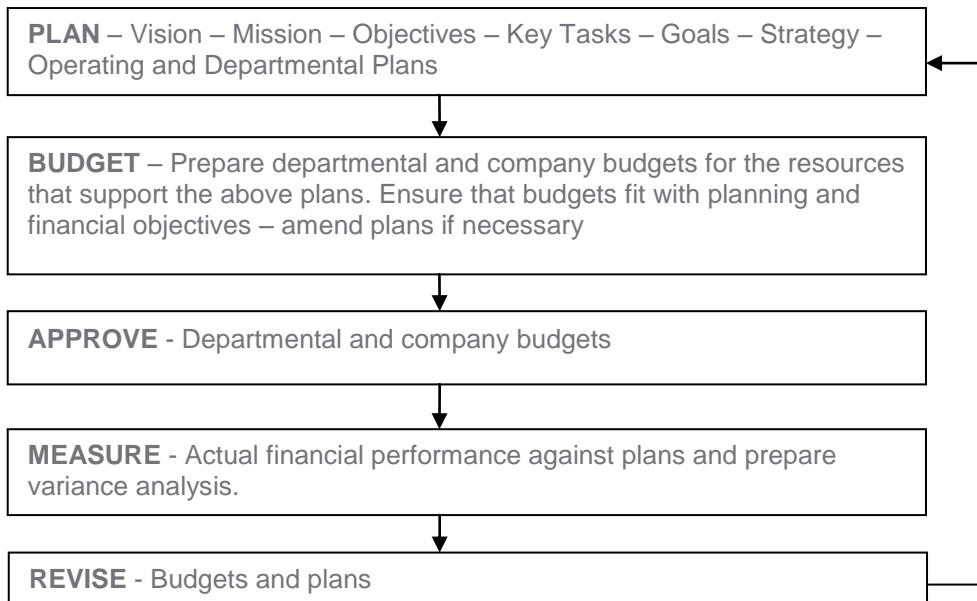
Definition

A budget is a financial evaluation of a plan. The budget process follows the planning process. However, it is also part of a planning process because once the financial consequences of a plan are known the plan may need to be revised.

Principles of budgeting

1. An integrated planning and budgeting process

The planning and budgeting process outlined below shows how budgets are integrated with plans. Budgeting and planning is an iterative process.



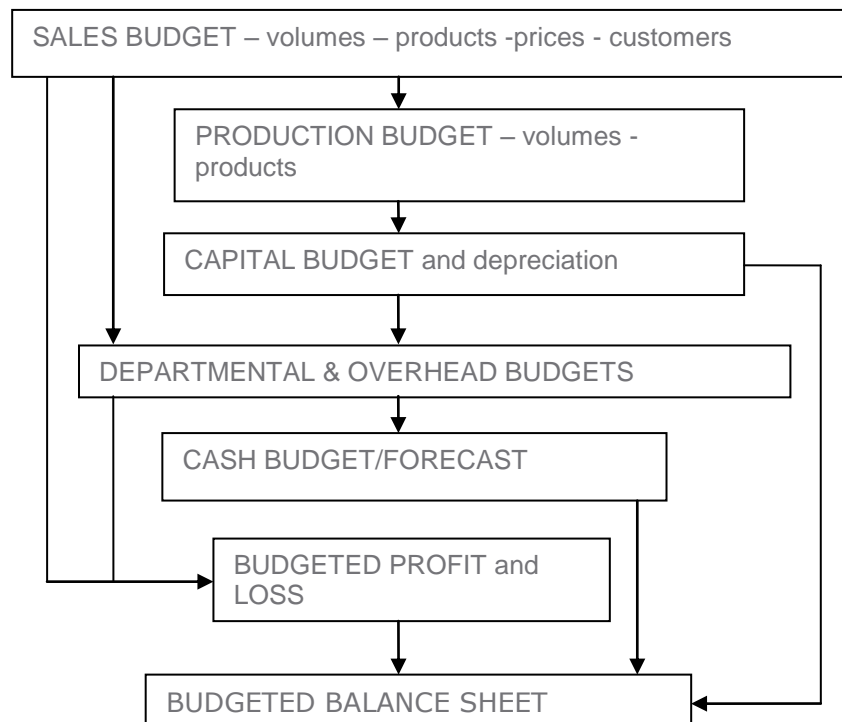
2. Zero-based budgeting

If possible budgets should always be zero-based. A zero-based budget (ZBB) assumes that each year the budget holder starts from scratch and has to justify every item of expenditure to support the operational strategy, key tasks and goals.

3. Budget dependencies

Some budgets will be dependent upon other budgets. For example, a budget for plant and equipment (a capital budget) might be dependent upon the requirements of production. However, the production budget may be dependent upon a sales budget.

A typical hierarchy and budget dependencies could look as follows:



There are no hard and fast rules to budget dependencies; each business will be different. However, you will have to start somewhere and the sales budget is usually the starting point that triggers other budgets.

As a manager it is likely that you will only be required to complete your own departmental budget. However, having an overview of the whole process will enable you to get a better understanding of your company's planning and budgeting cycle.

Monitoring performance against budgets

1. Departmental budgets

Departmental budgets for operating costs and capital equipment are what most managers will have to control. Operating costs include items such as wages, rent, power, stationary, travel, and other costs involved in the performance of approved departmental activities. Capital equipment costs are for fixed assets such as vehicles, equipment, furniture and other items that are used but not totally consumed within the budget period.

When preparing a budget for approval a manager will estimate what resources are needed to achieve the goals and key tasks that have been agreed during the planning process. A manager may want to consider what was spent in the previous year to get a feel for the cost of certain items. However, a manager should never simply take last year's actual costs and repeat them as the current year budget. This is because it would not be zero-based budgeting! Repeating last year's costs will not justify a budget against approved key tasks and goals in the plan. However, few managers will complete their budget without being aware of what was spent in the previous year. Looking at previous years' figures may help a manager to avoid missing certain items and to determine their cost.

A work sheet for a departmental operating budget could look like this:

Accounting department budget for 2013

Resource	2012 £000s	2013 £000s	Key task Reference	Comments
Salaries	300	310	2	Inflationary pay increase 3%
National insurance	15	16	2	Budget increase
Recruitment costs	20	5	2	Staff retention
Training	25	5	1	Reduction due to staff retention
Travel	20	5	4	Fewer trips to branches
Entertainment	1	0	2	Not required
Accounting software	1	8	2	Software upgrades/support
Stationary	5	3	2	Less paper and print
Share of overheads	17	17	2	No change
Total	404	369		

Each item in this budget has been justified by relating it back to an approved key task within the operating strategy. For example, key task number 2 could be 'to meet company legal obligations to file statutory returns.' Some businesses may not use the term 'key task' but might use some other term. Whatever term is used the important point is to ensure that departmental expenditure is justified and linked back to an overall business plan.

Budgets are likely to be completed using an Excel spread sheet. The above example is for one department showing the resources used. This may be termed a resource budget. Using Excel it would be easily possible for the accountant to consolidate the departmental budgets showing the overall cost of resources used. The Excel spreadsheet could also pivot to show the cost of each key task. Both consolidating and pivoting different views enable strategic decisions to be made.

Some departments may require additional capital equipment (fixed assets) and will prepare a capital budget. This is prepared on a different form to operating expenditure. Capital costs for fixed assets are not consumed within a budget year. For example, a van might be used in the business for 6 years.

Capital budgets must support organisational goals. It may be that new plant is required for a new opportunity that has been identified in the plan or that there is an opportunity to improve efficiency. Capital expenditure is an investment that will have to be justified and shown to provide the required return on investment.

Capital expenditure has funding implications. Additional long term funds will need to be found.

A typical capital budgeting process will include:

- the recognition of an opportunity
- links with corporate goals
- initial cost estimates
- the identification of financial benefits
- an evaluation, net present value, payback etc.
- the identification of alternative investments and prioritisation
- a proposal
- a decision.

The department responsible for the capital project should submit details to the finance department showing the cost, expected life, month of delivery and residual value.

2. Reporting of actual expenditure against budget

Once budgets have been approved it will be necessary to report actual expenditure against budget and explain variances.

Example of a year to date budget v actual expenditure report in £000s

Resources	YTD Budget	YTD Actual	Total Variance	Rate	Additional Outlay	Timing
Salaries	260	250	10		10	
Travel	25	30	(5)	(5)		
Entertainment	15	10	5			5
Stationery	25	30	(5)		(5)	
Training	30	40	(10)	(5)	(5)	
Allocated overheads	90	90	0			
Totals	445	450	(5)	(10)	0	5

Notes:

- 1) The total variance is (5) – adverse. Actual expenditure has exceeded budget.
- 2) There are 3 possible reasons for a variance:
 - Rate – where there has been a change in the rate charged for an item.
 - Additional Outlay – where more items have been purchased at the same rate as budgeted.
 - Timing – where the item will be purchased in a month different to that which was budgeted.
- 3) YTD = Year To Date – for simplicity it is often better just to consider YTD figures.

3. Variance analysis calculation

Example:

Budget is for 10 KG of powder @ £5 per KG	£50
Actual is 12 KG of powder @ £4 per KG	<u>£48</u>
Total Variance is	£2 Favourable

This is due to:

Additional Outlay - 2 KG @ £5	£10 Adverse
Rate – 12 KG @ (£4-£5)	<u>£12</u> Favourable
Total Variance is	£2 Favourable

A timing variance would simply reflect that the powder had been purchased in an earlier or later month than budgeted.

Nearly all variances can be explained under the categories of rate, additional outlay and timing. Budget holders should get used to this discipline. It provides consistency of approach and avoids lengthy explanations that cannot be consolidated by the accountant.

Some basic budgets

Budget holders should only ever be responsible for expenditure they can control. True control can only be done at the point of commitment although this can be assisted by periodic reporting of actual against budgeted expenditure.

The basic budgets in most organisations are:

- Sales revenue budget
- Production budget
- Materials budget
- Labour budget
- Overhead budgets
- Research and development budget
- Capital budget

Sales budgets

Sales budgets are key budgets because most other budgets depend upon and support the requirements of sales budgets. For example, the production budget will depend on how much product is to be sold and delivered and the sales budget might be constrained by production capacity. The sales budget shows volumes and prices for each product. The volume forecast depends upon demand, the ability to compete and production capacity. Price is determined by the market. In an efficient market it will be set by the interaction of supply and demand.

Avoid optimism in a sales budget! This is because the sales budget is the key to most other budgets. Production capacity, sales force recruitment, advertising budgets and capital budgets are examples of budgets that are dependent on the sales budget.

When preparing a sales budget check:

- the basis for the volume assumptions
- that there is production capacity to meet the forecast sales volumes
- that forecast sales fit with the company's overall plans
- that the demand is real and that there are no territorial overlaps
- that growth assumptions are real
- that the competition is fully understood
- that sales prices are realistic and achievable
- that marketing can provide the promotion required.

Once the sales budget has been approved this will be passed to the production manager to prepare a production budget.

Production volume budgets

The production volume budget determines production hours required to produce the volumes of products in the sales budget, taking into account both opening and closing stocks. The production budget will help determine the plant capacity required and capital expenditure. Plant and machinery may be identified as a limiting factor in meeting production and sales volumes.

The production budget will identify the number of direct labour hours required and also the amount of material required. This will feed in to the direct labour budget and a direct materials budget.

Direct materials budgets

The direct materials budget determines how much material is required to produce the production budget volumes. Material usage is charged at cost or standard cost to give the direct materials budget.

Direct labour budgets

The direct labour budget takes the required labour hours identified in the production budget and calculates the cost of labour using labour rates. This budget identifies labour requirements and recruitment costs.

A labour budget is prepared for each production process. If standard costing is used, the labour rates will become the standard rates used

Budgeted contribution

When the sales budget and the direct material and direct labour budgets have been prepared it is possible to calculate the budgeted contribution (gross margin).

For example:

2013 Budget:

Sales	£1,200,000
Direct labour	(£140,000)
Direct materials	<u>(£360,000)</u>
Gross profit (contribution)	£700,000

Gross Margin % = $700,000/1,200,000$ 58%

The gross profit before any allocation of overheads is the contribution towards fixed overheads and profits. The gross margin percentage is a key 'dash board' figure. Actual against budgeted gross margin is always monitored very closely.

Overhead expenditure budgets

Certain departments in a company are not directly involved in the manufacturing or production process. Examples are; the finance and marketing departments. The costs of these departments do not usually vary with the level of production as do direct costs. Within a budget year they are generally considered to be either fixed or semi-fixed costs.

Sometimes the costs of one department are allocated to another department (another cost centre). This is a form of internal charging and may occur when an internal customer is identified. Internal charging works best when the internal customer has the ability to 'shop outside'. Things can get complicated and confusing and many managers and finance directors do not support this concept. However, many companies have some limited form of cost allocation from one department to another.

Research and development budgets

Research and development costs are generally considered under two principal categories:

- Pure research – where no particular market offering has been identified.
- Applied research – where a specific product has been identified.

Pure and applied research need to be budgeted separately because they have different accounting and taxation treatments. A research and development budget shows the costs of each project and differentiates between pure and applied research.

Capital budgets

Capital expenditure (sometimes referred to as CAPEX) relates to items that are not fully consumed within a budget period and requires a different accounting and, therefore, budgeting treatment. Examples of capital expenditure are; buildings, equipment, fittings of a permanent nature, large main frame type computers (generally not PCs), motor vehicles and improvement to existing assets.

Because capital expenditure is not totally consumed within the budget year it is not written off to the profit and loss account. It is shown in the balance sheet as an asset and only the portion of capital expenditure used within the year (depreciation) is written off. There are a number of ways of estimating depreciation and it is usually calculated by dividing the asset cost, less any residual value, by the expected life.

The taxation treatment for capital expenditure in the UK is usually through a system of capital allowances.

Capital expenditure requires a particular board approval and sanctioning because it is an investment decision rather than just an ongoing operational decision. Once a capital budget has board approval, the executive responsible for the capital project will normally be required to go back to the board for capital expenditure approval before a final order is placed with a supplier. It will also be necessary for the finance director to arrange suitable long term funds term loan or equity.

Capital rationing

Capital is a scarce resource and it may not be possible to undertake all of the capital projects in a budget. Choices may have to be made. These will normally seek to maximise overall profits.

Projects can be ranked in terms of their Net Present Value (NPV). The NPV is simply the total of the present values of the cash flow of a project.

The present value (PV) of a future value (FV) is:

$$PV = FV \times \frac{1}{(1+r)^n}$$

Where: PV = Present value

FV = Future value

r = Compound rate of interest or discount rate

n = the period or number of years.

Example: A project yields £6,000 in 3 years time. The rate of inflation is 5% p.a. The present value would be:

$$PV = £6,000 \times \frac{1}{(1+0.05)^3}$$

$$PV = £6,000 \times \frac{1}{1.158}$$

$$PV = £6,000 \times 0.864$$

$$PV = £5,184$$

If a business only has a limited amount of capital to invest then it will seek to maximise its return by investing in those projects that produce the highest net present value.

Example: A business has £2,000 to invest and there are 3 project options as follows:

Project	Outlay	NPV	Return
Project 1	£600	£300	50%
Project 2	£900	£414	46%
Project 3	£700	£266	38%
Totals	£2,200	£980	45%

Assuming that the projects have to be completed in total or not at all then the business might select Project 1 and Project 2. Selecting projects 1 and 2 would produce the highest net present value as follows:

Project	Outlay	NPV	Return
Project 1	£600	£300	50%
Project 2	£900	£414	46%
Total	£1,500	£714	48%

Investing £1,500 in projects 1 and 2 of the £2,000 of available funds produces an NPV of £714.

Capital rationing decisions are an essential part of the budget process. They can get complicated!

Action checklist

1. Choose the right approach to budgeting

In most organisations the finance director will choose the method of budgeting to be adopted. As a manager you need to understand the method adopted.

The principal approaches to budgeting you are likely to encounter are listed below.

- **ZBB – Zero based budgeting** This starts with a 'blank sheet' and largely ignores what has been spent in previous years. Each item has to be justified against planned key tasks and goals.
- **Resource budgeting** – Often referred to as 'last year's costs plus a bit'. For the reasons we have discussed this method is not favoured but is still widely used!
- **PPBS – Planning, Budgeting, Programming System** This system budgets for programmes of activity – pivoting the resource budget against programmes. This system started in the US military and is used in a variety of adapted forms.
- **Flexible budgeting** – This system simply allows for interim changes to the budget as explained in the diagram of the iterative planning budgeting cycle.
- **PBB – Priority Based Budgeting** This considers priorities and scarce resources in a way similar to that described above under capital budgeting prioritisation.

Most finance directors will choose a combination of ZBB and Resource Budgeting.

2. Allow sufficient time to produce your budget

The finance director will produce a budget timetable some months before the start of the budget period. Schedule this in and allow sufficient time to produce a meaningful budget. It is a good time to examine all your activities and costs. Expect last minute changes as the process nears completion.

3. Link your budget to the plan

Make sure that you can link each item of expenditure back to a key task, goal or in some way back to the plan.

4. Show your budget in two dimensions

Your budget should show the estimated cost of resources and be capable of pivoting to show the cost of each key task/goal.

5. Training and participation

Obtain training from your finance director and ensure that your staff participate in the budget process and share ownership of it.

6. Chops and changes!

Planning and budgeting is an iterative process. Your finance director will do his best to ensure that key budgets (such as sales) are completed and agreed before other departmental budgets are prepared. However, once figures are consolidated the executive team may require cuts and changes. This will come back down the line. You need to allow sufficient time to accommodate changes.

Managers should avoid

- basing a budget on the previous year's spend alone
- allowing spreadsheets to become excessively complex and cumbersome
- forgetting to link their budgets to organisational goals and key tasks
- confusing operating expenditure with capital expenditure
- underestimating the time it takes to produce a meaningful budget
- starting their budget calculations before plans are agreed.

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National Occupational Standards for Management and Leadership

This checklist has relevance for the following standards:

LE: Manage the use of financial resources, unit A3

LE: Manage budgets, unit A4

Additional resources

Books

Financial Management for Non Financial Managers, Clive Marsh

London: Kogan Page, 2012

The Financial Times essential guide to budgeting and forecasting: how to deliver accurate numbers,

Nigel Wyatt

Harlow: Pearson Education, 2012

Mastering Financial Management: a step by step guide to strategies applications and skills, Clive

Marsh

Harlow: Financial Times Prentice Hall, 2009

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Related Checklists

Drawing up a budget (042)

Controlling a budget (043)

Financial forecasting (251)

Internet resources

Creating effective budgets <http://businesshelp.lloydstsbbusiness.com/planning/financing/budgets>

Guide to business budgeting provided by LloydsTSB.

Organisations

The Institute of Chartered Accountants in England and Wales, Chartered Accountants' Hall, Moorgate

Place London EC2R 6EA

Tel: 01908 248 250 Web: www.icaew.com

The Chartered Institute of Management Accountants, 26 Chapter Street, London SW1P 4NP

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Incremental Budgeting

Incremental budgeting is the traditional method of preparing a budget forecast. It involves taking the previous years' budget and adding incremental amounts for the new budget period to meet the new situation, rather than starting from nothing as with Zero Based Budgeting (ZBB). An incremental budget treats existing programmes and departments as already approved, subject only to increases or decreases in the financial resources allocated.

The organisation's historical costs are the base from which planning starts. The focus of the budgeting process is on the changes anticipated in last year's figures. If activity levels have changed, there may be a much more efficient and cost-effective way of organising things. Adjustments may include: increases in prices, increases in costs, costs of additional activities and reductions caused by deletions to the budgeted activity.

Advantages	Disadvantages
Budgets can be drawn up quickly with little discussion required	Activities not reviewed rigorously. Assumes activities and methods of working will continue in the same way.
Co-ordination between budgets easier to achieve	No incentives to reduce costs
Budget is stable and change is gradual	It can encourage "spending up to the budget" to ensure a reasonable allocation in the next budget period, which can lead to a "spend it or lose it" mentality.
Conflict should be avoided if departments can be seen to be treated fairly	The budget may become out of date and no longer relate to the level of activity or type of work being carried out
Relatively simple to operate and easy to understand	Priority for budgets may have changed since the budgets were originally set
Impact of change can be seen quickly	Questions not asked about relevance or usefulness of the activity

How can this help me? Incremental budgeting is often less time-consuming than the zero-based method, and is also felt to be less threatening to programme managers although, it does fail to take into account changing circumstances.

Find out more – Read *Drawing up a Budget* (CMI management checklist 042)

Zero Based Budgeting

Zero based budgeting (ZBB) is an approach to budgeting that starts from the premise that no costs or activities should be factored into the plans for the forthcoming period, just because they figured in the costs or activities for the current or previous periods. Rather, everything that is to be included in the budget, must be considered and justified. ZBB goes as far as to prompt the question: 'Do we need the activity or service in the first place'.

There are three steps in the ZBB process:

1. Analysis/identification of the organisation into budget centres which are task oriented and referred to in ZBB as decision units. The idea of the decision unit is that of dividing the organisation into a series of meaningful sections which form discrete parts, each of which is the responsibility of a manager and each of which undertakes a main activity.
2. Development of decision packages, involving considering whether the decision unit's activities should be continued at current levels, eliminated or changed. Consider alternative methods whereby the unit's objectives can be satisfied, decide the minimum level of service which would make it worthwhile retaining the unit, decide on the incremental costs and benefits required to provide improvements in service above the minimum level.
3. Ranking of activity levels initially at departmental level, then divisionally and finally for the organisation as a whole.

ZBB is concerned with getting value from overheads and is intended to help an organisation to:

- allocate resources between essential and less essential activities
- improve decision making because the allocation is related to the analysis of objectives
- facilitate planning, i.e. requires managers to look ahead at their future needs rather than beginning with their current activities
- encourage creative thinking in requiring each manager to state an alternative way of achieving the results at each level, i.e. to consider how we could improve this service to the organisation
- gain the commitment of managers from the 'bottom up' rather than their defensive compliance to constraints set by senior management; it therefore, fosters accountable delegation
- reduce overhead costs.

How can this help me? When properly implemented in an organisation, ZBB can assist managers to plan and make decisions about the most efficient and effective ways to use their available resources to achieve their defined mission, goals and objectives.

Find out more - Read *Cost control: a strategic guide* by David Doyle.