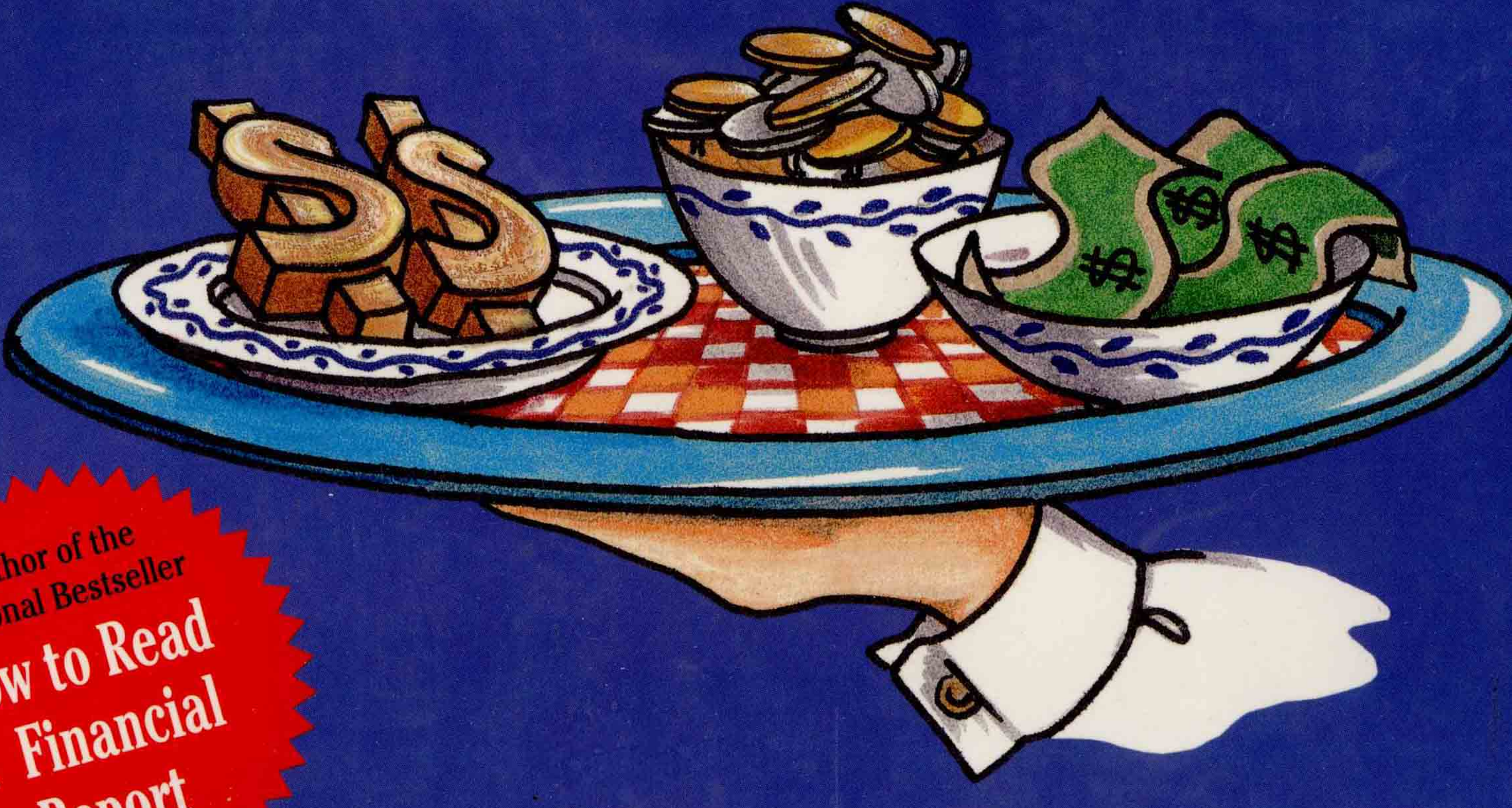
BUDGETING À LA CAR

ESSENTIAL TOOLS FOR HARRIED BUSINESS MANA



Author of the
National Bestseller
**How to Read
a Financial
Report**

John A. Tracy

Budgeting à la Carte

Essential Tools for Harried Business Managers

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Author of the national bestseller
How to Read a Financial Report, Fourth Edition

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For my two sons,

John and Tage,

and my three daughters,

Mary, Chris, and Jackie

PREFACE

To be honest, I nearly abandoned this book idea. John Wiley & Sons asked me some time ago to do a book on budgeting, and in a weak moment I agreed. Then I had serious second thoughts. Why write another book on budgeting when there are already many budgeting books on the market? Could I really offer anything new and different? Could I build a better mousetrap?

Then there was a change of editors at Wiley. I met with Myles Thompson, my new executive editor. Lee Thompson, vice president of marketing, also attended the meeting. For our meeting I prepared a sample chapter, which evolved into what is now Chapter 1, "So, Why Budget?"

In thinking about this chapter I came to see that other budgeting books take the "whole nine yards approach." They treat budgeting as a *system*. Their premise is that you have to buy the whole system, not just parts of it. Of course, many business organizations have adopted a budgeting system. They have put into place comprehensive and formal policies and procedures for management planning, authorization, and control. But budgeting does not have to be bought as a system, or as a whole meal from appetizers through dessert. From this book's title, you can plainly see that I take a different approach. Like walking through a cafeteria line, business managers should select only what they really need and can put to their best use.

At our meeting I presented the sample chapter for my new executive editor and the marketing vice president. They liked it. The more we talked, the more enthused I got about doing the book. Also, I got a real bonus in the deal. Bari Zahn, Esq., became my editor and worked closely with me in developing the book. The book is immensely better for her keen insights and suggestions. She's one hell of a line editor; no sloppy sentences get by her beady eyes.

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Budgeting à la Carte is written mainly for business managers. Other business professionals may find much useful information in the book—especially how a business makes profit, what determines cash flow from profit, and the capital needed to support profit-making operations. In it I break down budgeting into its separate parts and different analysis tools. Although short, this book includes quite a few chapters. I chose this format to keep the explanation of each topic brief and to the point, so you can learn quickly what advantages it offers and how to use it.

This book explains the purposes, advantages, essential steps, and analysis tools of budgeting for businesses in all stages of their life cycles. However, I do not discuss implementation practices and issues, such as the Budget Director's role, the budget calendar, and the communication problems of budgeting in larger organizations.

Budgeting à la Carte will help managers in accomplishing the three financial objectives of every business:

- To make profit
- To plan and control the capital invested in net operating assets needed for making profit
- To generate cash flow from profit

For each of these three business financial imperatives there is a corresponding financial statement: the profit report (Income Statement); the financial condition report (Balance Sheet); and the cash flow report (Cash Flow Statement). These three financial statements form the essential framework of budgeting. You can't get too far into explaining budgeting without demonstrating what you mean with financial statements.

Early in this book I review these three primary financial statements from the *manager's* point of view, in contrast to external financial reporting. External financial statements are prepared in accordance with generally accepted accounting principles (GAAP), which in actual practice have become minimum accounting and disclosure standards that very few external financial reports go beyond. For decision making and control, managers need more information than what is found in external financial statements. In fact, much management information is very confidential and would never be included in an external financial report open to public view.

Budgeting is an integrative process; different pieces of the financial puzzle have to be fitted together. Of particular importance are the relative sizes between revenue and expenses of a business and the operating assets and liabilities needed to carry on its profit-making operations. For instance, if annual sales revenue is $10 million how much should accounts receivable be? *Operating ratios* are the measures of these interconnections between the assets and liabilities reported in the balance sheet and the revenue and expenses reported in the income statement. The balance sheet and income statement are fitted together tongue-in-groove with operating ratios. Operating ratios are the absolute starting point for budgeting. Hence, this book discusses operating ratios in some detail—an essential topic that is not explained in other budgeting books.

Budgeting à la Carte then moves through additional budgeting topics and tools of analysis. The chapters rest on a decision-making foundation. The focus never strays from the key profit and cash flow factors that managers must make decisions about and must control. The final two chapters deal with capital investment analysis and shy away from the wrong-headed mathematical and equation-ladened approach of other books.

Again, I thank Myles and Lee for their encouragement and ideas. I'm especially indebted to Bari for her excellent editing on the book. Last, I would like to remember my father who died more than a decade ago. He never finished high school during the Depression, but he ran a business for many years. He taught me much about business. He was looking over my shoulder while I was writing this book.

JOHN A. TRACY

Boulder, Colorado
June 1996

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SO, WHY BUDGET?

To the Busy Business Manager

The last thing you need is a sermon on budgeting, so I'll skip the usual exhortations about the purposes and advantages of budgeting. And I won't treat you as a sinner if you don't do any budgeting. You may have the right approach to budgeting already. Then again, you may not. Which is what this book is all about.

Chapter 1 presents an overview of budgeting for the busy business manager. I will not try to sell you on the idea of budgeting as a system. Not every business needs a complete, full-blown, formal budget system typical in the large business organization.

Even a large corporation should be frugal in doing budgeting. The budget should be budgeted. Any budget system worth its name should be put to a ruthless cost-versus-benefits test. The large corporation may do too much budgeting–going through rituals that have little management value. Other businesses may do too little budgeting and fail to take advantage of one or more budgeting techniques that would have a high payoff.

I know your time is scarce. But I also know that you want to keep your business profitable and solvent. The key question facing the busy business manager is how much budgeting to do—to identify and make efficient use of those particular techniques that can improve profit, cash flow, and financial condition.

The System Versus the Parts

Most books and articles discuss budgeting as a system. The presumption is that you have to adopt and implement a whole budgeting system or none at all. However, this is nonsense. You shouldn't look at budgeting as a monolithic system that you have to buy into on an all-or-nothing basis. The word *budgeting* is an umbrella term covering a diversity of separate elements and distinct techniques. A business has to be fairly large—I'd guess perhaps $100 million or so in annual sales revenue—to justify the cost of implementing budgeting as a truly comprehensive and coordinated system throughout the organization.

In the smaller business the owner-manager is the "system." The owner-manager doesn't have to put all the budgeting pieces together into a system. Even in fairly large organizations, it may be best to focus on the pieces of budgeting rather than looking at budgeting as a system.

So, let's think of budgeting as a toolbox—one stocked with a wide variety of tools. Few of us use all the tools a professional mechanic needs, but we often use screwdrivers, pliers, hammers, and wrenches. Business managers may think they don't have the time or can't afford to use any budgeting tools, but some tools in the budgeting cabinet can be very helpful and well worth the cost. For example, using just one or two budgeting tools may have a high payoff to the small business, even if it does not have a budget system.

To sum up: I am not advocating a seven-course dinner budgeting system. Rather, I am offering budgeting à la carte, in which you, the busy business manager, can select from the items offered to suit your particular business situation, in an effort to protect and improve financial performance and position.

Business Budgeting Versus Individual and Government Budgeting

Please don't confuse *business* budgeting with the budgeting done by individuals and households or with the budgeting done by government. Budgeting by individuals, households, and by government agencies is driven primarily by the need to allocate scarce resources among excessive demands and to stay within these allocated amounts once the budget is adopted.

Given their limited incomes and existing debts, individuals find it helpful to rank order and prioritize their needs and preferences. Some items may have to be removed from their shopping list. Budgeting also draws attention to the cost of each item, which may lead to cost-saving tactics.

Cost savings are as good as additional income, even better as a matter of fact. Cost savings are not taxable to individuals, whereas additional income is taxable. Three dollars of cost savings provide three additional dollars of spending power. On the other hand, receiving three dollars of additional income generally increases taxable income by the same amount, thus generating about one dollar of additional income tax and leaving only two dollars for additional spending. (A technical note: this assumes the costs savings are in nondeductible expenditures.)

Governments, from the federal level to the local school district, have only so much revenue available, and they have to make difficult choices regarding how to spend their limited tax revenue. In fact, formal budgeting is legally required for almost all government entities. Furthermore, once money is appropriated and the budgets are adopted the budget imposes rather strict spending limits.

Certainly there are some common features between business budgeting and budgeting by individuals and governments, but the differences are more important. A business doesn't have limited or constrained revenue as such; its revenue depends on making sales.

The allocation of scarce resources is not the main driving force behind business budgeting. Sales revenue brings with it certain costs and expenses necessary to generate the sales revenue. The goal in business is to make the "optimal matchup" of its revenue on the one side with its costs and expenses on the other side. This does not necessarily mean minimizing expenses.

Budgeting for Better Management or for Better Profit?

The dominant and overriding purpose of budgeting is to protect and improve financial performance and position. Financial performance means both the *profit* earned by the business and the *cash flow* of the business. Financial position refers to the efficient use of *capital* by the business (found on the asset side of its balance sheet) and the *liquidity* and *solvency* of the business, which means its ability to meet the obligations found on the other side of its balance sheet (in the several liability and owners' equity accounts).

I want to make this very clear at the start because, surprisingly, the large majority of discussions on budgeting do not stress the

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bottom line or financial purposes of budgeting. Instead emphasis is placed on the "best management practices" reasons for budgeting. The underlying theme is, "you want to be a good manager, don't you?"

Of course good management should lead to good profit, good cash flow, and a good financial condition. Who could argue with this? But more to the point, I assume that as a business manager your eye never strays very far from the financial bottom lines of the business—profit, cash flow, and financial condition. So I approach budgeting from this viewpoint.

Budgeting Up Close

Budgeting consists of separate elements, procedures, techniques, and purposes. Each has its own management function and value. In this section we take a brief look at each of these budgeting "pieces." The more comprehensive the budget and the larger the business organization, the more critical it is to put the budgeting pieces together into an integrated and coordinated system. On the other hand, any business can profitably use just one or two of the pieces without using the entire system.

Accounting Reports to Managers

The typical accounting system is designed mainly with two things in mind: (1) the preparation of tax returns and (2) the preparation of the financial statements included in the external financial reports of the business. Budgeting puts additional demands on the typical accounting system. The company's accounting system may have to be modified to improve the format and content of accounting reports to managers.

Accounting reports to managers should *not* be facsimiles of the company's external financial statements. True, management accounting reports contain more detail about the expenses of the business not reported in the external financial statements (income statement). But otherwise the classification of expenses tends to be the same. This won't do for budgeting.

External financial reports go to the creditors and outside investors in the business. Managers should understand them, of course. Managers are responsible for their financial statements and the other disclosures in the external financial reports. But external financial reports are not adequate for management use. One demand of budgeting is that the internal accounting reports be reexamined and redesigned for better management analysis.

Vision, Strategy, and Goals

It is surprising how many businesses—and I'm sure your business is the exception of course—suffer from not having a clear mission statement or a clearly stated strategy and do not have definite and explicit goals to serve as benchmarks to measure achievement and progress toward their objectives. The business manager may have all this information in his or her mind, but it may not be made explicit or written down.

The foundation of budgeting is the articulation of the fundamental concept and "story" of the business, including its general strategy for success and the quantification of its goals in observable numbers. This provides the basic anchoring for the budgeting process and for the comparison of actual outcomes against the budgeted objectives.

Planning

Planning means getting down to brass tacks—putting together an action plan on paper that spells out in detail how objectives and goals will be achieved, when things will be done, who will do them, what products will produce how much profit, how much cash flow will be generated from profit, how present problems will be corrected and not repeated in the future, and so on.

In the minds of many, budgeting is almost synonymous with planning. Planning, however, refers more specifically to following through on all the details that have to be incorporated in the budget once the basic vision, strategy, and goals have been adopted.

The busy manager may not take the time to do enough planning. However, budgeting is a strong incentive to set aside enough time to prepare a plan in sufficient detail to serve as a good road map for the business.

Change Analysis

All business managers should take time to focus on changes that will affect the business—to anticipate changes in time to prepare for them, rather than waiting for the changes to happen. One element of budgeting is to examine and analyze what will happen to the business as a result of such anticipated changes and to think out how the business plans to handle the changes.

Business managers are aware of the multitude of changes buffeting the business this way and that. It's one thing to be generally aware of changes; it's quite another matter to analyze in sufficient detail the effects that will be caused by the changes. Budgeting, from this viewpoint, is the technique to analyze the effects of changes and how to deal with them.

Forecasting

Forecasting may be used in planning and change analysis, but technically it is a separate activity. Forecasting uses certain "scientific" tools and techniques, such as statistical trend analysis and business cycle analysis. Many larger businesses make use of very sophisticated econometric models of the entire economy and the major segments of the economy having the most impact on their markets.

Inflation rates, unemployment rates, the prime interest rate, and hundreds or thousands of other economic variables are thrown into the computer model. The primary purpose is to take output from the forecast model to determine the impact on demand for the company's products, its costs of operations, and its other business variables.

Forecasting can be very expensive. Designing, developing, and constantly updating a large-scale, computer-based forecasting model is quite expensive. Even some very large corporations do not do all their own forecasting in-house. They buy the forecasts and analysis reports from economic consultants and universities. On the other hand, much forecasting type information and many opinions are found "free" in the financial press in articles and editorials that project the broad trends in the economy. Trade associations also publish more specific types of forecast information that even small businesses may find useful.

Modeling Profit, Cash Flow, and Financial Condition

To do budgeting you need a fairly good analytical grip on the business. In other words, a good budget is based on a good analytical model or set of financial specifications of the business. The model should capture the causes and effects of profit, cash flow, and financial condition of the business.

The basic factors that propel profit, that drive cash flow, and that determine financial condition should be connected with one another. The relationships among the key factors need to be identified and put into definite measures called *operating ratios*. This sort of financial model of the business is a very useful management analysis tool.

Motivation of Managers and Employees

Although there is no small amount of debate and disagreement on this point, the consensus is that budgets have a good motivational impact on employees and managers and serve as strong incentives to managers to strive for and achieve the goals and objectives of the business. The main point is that budgets can both reward good results and punish bad results.

One key assumption behind this line of reasoning is that the budgeting process is done well, which usually means there is a fair amount of participation by everyone who is accountable under the budget and that the goals of the budget are realistic without being too easy. The behavioral premise is that managers need to know the game plan of the business to know what's expected of them, and they need clear-cut feedback regarding whether they are performing at satisfactory levels.

Business Plan

To raise capital the new or emerging business usually has to put together a convincing business plan. Since these businesses have little or no history, the business plan must show that the manager(s) have thought out all major aspects of the business with a clear strategy—including marketing its products, manufacturing or purchasing its products, the labor force of the business, and the competition. It must be a persuasive document to convince bankers to make loans and venture capital firms to invest in the business.

One essential component of the business plan is the pro forma financial statements of the business for the next year and beyond. These projected financials must be as convincing as the marketing plan. Raising too little capital to survive and to grow is one of the chief reasons the majority of start-up businesses fail. There are many reasons for the failure of start-up business ventures, but the lack of adequate capital planning is always in the top five or ten reasons.

The tools and procedures of budgeting are very helpful for putting together sound and realistic financial statements for business plans. In fact, if the start-up business makes clear in its business plan that it has used budgeting procedures this in itself probably will add credibility to the plan.

Cost and Expense Control

One element of budgeting has been deliberately delayed to this point in the discussion. The reason may be obvious, but maybe not. Keep in mind that this book is directed to business budgeting, not individual or government budgeting. Individuals and governments use budgets for cost control, because their primary purpose for budgeting is the allocation of limited revenue. The allocated amounts for each item become spending limits.

The financial goal of business, on the other hand, is not primarily to keep its expenses and costs within preset limits but rather to optimize its profit performance, which depends on *profit margins*. The best profit margin is not necessarily the situation with the lowest cost and expense. Profit margin is the spread between sales price less cost and expenses. A better profit margin may require a higher level of costs and expenses that is offset by an even higher sales price.

On the other hand, certain costs and expenses of a business are not directly in the profit margin equation. These are called *fixed* costs and expenses. Establishing control limits for these may not be a bad idea. If a budgeted control limit is hit, the preset amount acts like a circuit breaker that prevents any further expenditure until management reviews the situation and authorizes an additional amount.

Communication

Budgets are generally touted as a good means of communication of the goals and expectations of the business organization. It's not always clear what exactly the term *communication* really means, however. Once adopted, a budget certainly must be made clear to all those responsible for meeting the goals and objectives of the budget. The budget could hardly be kept a secret.

Often the implication is that the budgeting process improves the communication throughout the different units, departments, locations, and divisions of the organization. Keep in mind that business organizations make use of many means of communication. The budget is just one of many means. The communication reasons for budgeting depend very much on the size and culture of the business organization. The very small business probably would not use budgeting for communication purposes.

Performance Evaluation

The functions and roles of business executives and managers are defined and redefined endlessly—as leaders, motivators, innovators, change agents, peak coordinators, problem solvers, consensus builders, negotiators, conflict resolvers, and so on. Clearly business executives and managers perform many different functions. Personally I have observed that one key function of business managers gets second billing. Managers are *performance evaluators*.

Managers, among their wide variety of functions, have to take a hard look at what's going on and ask: How are we doing? Should we be doing better? Managers are professional evaluators, as it were. I suspect the reason this dimension of management gets short shrift is that it sounds negative and fault finding.

In developing objectives, goals, and targets, budgeting should help the performance evaluation function. Budgets lay out standards of performance in advance. The persons being evaluated should feel that they are being evaluated more fairly and not at the whims of higher level managers.

Compensation of Managers

Setting salaries for managers and deciding on incentive-based management compensation arrangements are no easy matters. Budgeting provides objective goals and standards of performance on which to base bonuses and salary increases. Many large and midcap corporations use a "make or beat the budget" approach for compensating managers.

For the small business, budgets can help the owner-manager decide on his or her salary takeout from the business, as well as the salaries of other key managers. The profit plan (budget) for the year can be used to award year-end bonuses according to whether designated goals are achieved.

Problem Identification and Solving

In setting financial goals—the key step in budgeting—managers often discover that the business should be doing better. Budgeting helps the manager identify problems that may otherwise go overlooked. Budgeting takes a hard look at the present level of performance and the present position of the business and asks: Is this good enough?

Nothing focuses attention on an issue so much as having to put a number on it. Take dieting. Are you overweight? Putting a number on what you should weigh is more likely to force you to go on a diet. Although certainly not the whole enchilada, it is important to manage a business by the numbers. Budgeting is clearly a big help in this regard. Budgeting is a tonic against creeping complacency with the present performance and position of the business.

Looking at Your Future Financial Statements

The business manager may find one aspect of budgeting rather intriguing and that is to look at your *future* financial statements today. The projected financial statements of the business for next year are the centerpiece of the budgeting process. There is a lot of value in looking ahead to where you are likely to be a year from now.

In this regard, business budgeting is like following out a savings/investment plan into the future to see if you will have enough money to send your children to college or to retire. Budgeting plots the financial trajectory of the business and takes a look at the future landing site, which might not look all that good or might be a pleasant surprise. But you don't know until you do it.

Costs and Pitfalls of Budgeting

Budgeting does not always go smoothly and in fact can lead to counterproductive results. And then there are the costs of budgeting.

I should mention as an aside that "no budgeting" doesn't necessarily mean no control. By management control, I don't mean the preventive aspects of control. Rather, I mean achieving the financial goals and objectives of the business. The emphasis is on the positive of accomplishment, not the negative of cost and expense control. Budgeting is helpful but not essential for management control. Many businesses don't do any budgeting, yet they make a good profit and remain solvent and financially healthy.

They depend on management accounting reports that track their actual profit performance, financial position, and cash flow. But they have no explicit budget goals or standards against which to compare actual results. More than likely they use last year as the reference for comparison.

The larger the organization, the more likely you'll find a formal and comprehensive financial budgeting process in place. The budget provides the benchmarks for evaluating performance of managers at all levels. Actual is compared against budget and significant variances are highlighted, which are investigated and reported up the line. Managers are rewarded for meeting or exceeding the budget, and they are held accountable for unfavorable variances.

But even large corporations admit that budgeting has its down side. Budgeting is costly and may lead to a lot of game playing and dysfunctional behavior. Managers have been known to manipulate the budget or sometimes resort to out-and-out fraud, massaging the numbers and cooking the books to make their "actual" numbers look good relative to the budget.

The most important cost of budgeting is the time it takes the manager to do his or her part of the budgeting process, as well as the time of other managers. I needn't tell you that your time is a very scarce commodity. You only have so much time, energy, and attention, which must be carefully apportioned among many competing demands.

Some of the mechanical procedures of budgeting—assembling the budgeted financial statements for example—can be done by your accountant or an outside CPA. But, make no bones about it—budgeting takes time. So it makes sense to select just those budgeting techniques with the highest payoff.

This book is based on this premise. In other words, we do not explore budgeting as a big business organization system and all that would entail. Instead, focus on those specific budgeting techniques that, in my opinion, have the most value—the best return on your time investment. You can get a good

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