

Magic Workbooks

Business Survival Manual

# BUDGETING

OR

*A Firm Grip  
on the Future*

A budget is a projection of a company's (or part of a company's as in a project budget) development into the future. Since the future is uncertain, a budget can never match future reality exactly. This is why, when we are talking about budgeting we are actually talking about a threefold process which comprises a budget, future actual figures and a projection which combines the best and most accurate features of both.

- ❖ **Budget**

- ❖ **Budget to Actual Comparison**

- ❖ **Projection**

The most common type of company planning is the budget for one year, usually divided into monthly or at least quarterly segments.

For the sake of easy comparison to actual figures, every budget should be in the exact format that is used for reporting purposes of actual figures.

Since the budget is a projection – from the past into the future – every budgeting process must start with a good look at the company's development in the past two or three years as well as the current results.

## **Budgeting Revenue**

What is the most sensible way of segmenting revenue for budgeting purposes: by product/service, by production/service unit or perhaps by both?

Let's look at a hotel company which operates three hotels. Each hotel is a production/service unit that needs to be budgeting separately. Within each hotel, the different revenue segments also have to be budgeted separately although the budgeting process for those segments will be roughly the same for all hotels if all provide the same range of service.

## **Building a Budgeting Matrix**

Your first step should be to build up a budgeting matrix e.g. in the form of an excel file. It could look something like this if you have to deal with more than one production/service unit and more than one segment of revenue:

Top Level (= Summary)

<b>Company Budget</b>		Year: 2015			
Month		Jan	Feb ...	Dec	Total
Rooms Rev.		12.000			
Restaurant Rev.					
Other Revenue					
TOTAL Revenue					

Production/  
Service Unit level

<b>Hotel 3</b>		Year: 2015			
Month		Jan	Feb ...	Dec	Total
Rooms Rev.					
Restaurant Rev.					
Other Revenue					
TOTAL Revenue					

<b>Hotel 2</b>		Year: 2015			
Month		Jan	Feb ...	Dec	Total
Rooms Rev.					
Restaurant Rev.					
Other Revenue					
TOTAL Revenue					

<b>Hotel 1</b>		Year: 2015			
Month		Jan	Feb ...	Dec	Total
Rooms Rev.		12.000			
Restaurant Rev.					
Other Revenue					
TOTAL Revenue					

To be summarized  
on the Top level

Product/  
Service level

<b>Other Rev. Budget</b>		Hotel 1 Year: 2015			
Month		Jan	Feb ...	Dec	Total
Tourist					
Walk-In					
Confere					
TOTAL					

<b>Restaurant Rev. Budget</b>		Hotel 1 Year: 2015			
Month		Jan	Feb ...	Dec	Total
Tourist					
Walk-In					
Confere					
TOTAL					

<b>Rooms Rev. Budget</b>		Hotel 1 Year: 2015			
Month		Jan	Feb ...	Dec	Total
Tourist		12.000			
Walk-In					
Conference					
TOTAL Rooms Revenue					

To be summarized  
at the Product/  
Service Unit level

## Calculation Level

Rooms Rev. Calc.	Hotel 1	Year: 2015			
Month	Jan	Feb	...	Dec	Total
Tourist					
Roomnights X	200				
Average Rate	60				
Total	12.000				

Once you have the structure that is needed to accommodate all production/service units and products/services you can start to fill the matrix with data.

If you are unsure of your structure check past financial reports until you have a reasonably firm grasp of the company.

You have to work strictly bottom-up by budgeting every segment and then transferring the segment totals up to the next budget level. You start with the lowest level which we have called the Calculation Level.

In our matrix example you can see how the revenue expected from tourist guests in the month of January “travels” upwards from the calculation level through the segment level to the unit level and finally ends up in the company level. (Since this is the first entry, the calculated amount equals the total at company level. Once the budgeting is underway, the company total will of course look a lot different from the totals at other levels.)

The calculation level is actually the expert level because on this level you have to use the calculation equipment necessary to determine revenues (and later on, expenses) according to the type of business you are dealing with. Everything else within the budget is just seeing to it that the figures are summarized and shown in the right place. The calculation level is where it counts!

## Calculating Revenue for different Business Types

If you look at our example again and you are not from the hotel industry you might find the terms “room nights” and “average rate” unfamiliar. Within the hotel industry these are the key calculation elements for rooms revenue segments.

In a production company you would calculate a product’s revenue by multiplying the number of units sold in one period by the average product price.

And in a consulting company you would estimate the revenue generated by a consultant as the product of client-hours and hourly wage.

The information you need to process at the calculation level is an integral part of the business lore of your company. Usually you will pick this up in a short time. If you are a total newcomer, try to talk to people in the company who are aware of these key figures and also work with them.

To get a feeling for these calculations at the core of your company it is a good idea to take last year's actual financial figures and break them down into their calculation components.

Suppose that the revenue for product 77 has developed as follows:

<b>Year</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
<b>Revenue</b>	<b>10.000</b>	<b>12.000</b>	<b>13.500</b>	<b>?</b>

What would be your educated guess for Year 4? Probably 15,000, right?

Now look at the calculation level behind those totals:

<b>Year</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
Units sold	500	600	900	<b>?</b>
Average price	20	20	15	<b>?</b>
<b>Revenue</b>	<b>10.000</b>	<b>12.000</b>	<b>13.500</b>	<b>?</b>

The number of units sold was driven up by a massive price reduction! You might want to check when in the course of year 3 that reduction took effect and how many units were sold at the old price and how many at the reduced price. Your estimate for the budget should be based on the latest unit price and sales development. And that would look somewhat different from your first guess, especially if another price reduction is in the offing, right?

The operating principle on the calculation level is this: understand how each segment of your budget is calculated, which key figures form part of that calculation process and where to get the key figures.

You may not always have to go down to the calculation level, some revenue segments may habitually be calculated as a percentage of some other revenue segment e.g. telephone revenue may be estimated at 3% of consulting revenue.

When faced with the decision whether it is necessary or worthwhile to go into great calculatory detail we recommend that you look at last year's figures in percentages of total revenue and total expenses. Any segment below 5% of total revenue or cost is not worth re-inventing the calculation-wheel for!

Concentrate your time and efforts on those segments which are of crucial importance to company profit and make sure you get them calculated as accurately as possible. And by "accurately" we mean, make sure that you have used all the information available in your estimate of future development.

## Budgeting Costs / Expenses

Everything said above about the matrix and budgeting revenue also applies to budgeting costs.

For budgeting purposes we subdivide costs into two major categories, variable and fixed costs.

Variable costs, as the name suggests, are those that fluctuate with part or all of the revenue.

Commissions might thus be calculated as 5% of total revenue which allows you to put that formula into the budgeting matrix and that's it.

But careful! If freight expenses were 5% of total revenue last year and you are dealing with major price reductions and an increase in units sold you might have to go down the ladder again to the calculation level and check the relation between freight costs and units sold and use that factor to come up with a more accurate estimate of future freight expenses for your budget.

The budgeting of fixed costs also has its pitfalls.

Here, you are usually required to work your way through any number of contracts. Rent expenses, for instance, form part of the fixed costs but that does not necessarily mean that they will be identical to last year's rental expenses. What does the rental contract say?

Electricity and other utilities may be fixed costs but that does not mean that State Gas & Electric will be satisfied with last year's prices. The same applies to insurances, and all other seemingly fixed costs.

**So, to summarize and generalize a bit:**

**Budgeting variable costs usually requires a lot of thought, and budgeting fixed costs takes a lot of work!**

# Budgeting Commentary

Let's go back to the Calculation Level for a minute. As we have said above that level is where most of your thoughts and estimates will be going.

To keep track of your thoughts, of how you arrived at a certain estimate and what sources (people's opinions, written materials, external data) you have used, you should enter all those into a budgeting commentary. That is easier and less troublesome than it sounds and it comes in handy when you have to justify your estimates later on or simply re-trace how you came by the material. It will also be of help for next year's budget (one does tend to forget where certain bits and pieces of information can be found).

If you are working with an excel file, simply use one worksheet for this additional information.

Here's an example:

<b>Budgeting Commentary 2015</b>		
<u>Type of Revenue/Expense</u>	<u>Item</u>	<u>Source / Commentary</u>
Tourist Revenue	# roomnights	Benson's travel agency + Forecasts all hotels

# Budgeting Periods

Most companies are prone to at least some seasonal variation in their business; some companies have to deal with major variations (Christmas decorations are hard to sell in July!).

This is why budgeting for one year should always be done on a monthly basis with a year-total column at the end.

If you have to budget for longer periods – say, the famous Commie 5-Year-Plan – you should revert to a yearly format using your latest year-end column as a guideline. Needless to say, the farther the budgeting period extends into the future, the more uncertain your projection will be. A mid-term projection therefore needs careful and constant revising in the course of time as the actual figures come in.

## Budgeting Help

If you are just starting your budgeting career and are not actively suicidal, you will need help.

Who can you count on in your darkest hours?

The guys and gals from the Accounting Department. Don't scoff! And don't start developing **Controllers' Syndrome!**

### **Controllers' Syndrome**

**A Vicious Mental Disease Causing Strange Hallucinations**

**...while I am effortlessly soaring through the pure heights of Calculation, the accountants down there are trudging the treadmill of stupid day-to-day ledger entries...**

It just so happens that by a **Perverse Mistake in Creation** Reality does not have to conform to your Budget – but vice versa.

And accountants happen to be in charge of Reality. They hold sway over revenue and costs as they are and if you ask them nicely they might just share their not inconsiderable insights with you.



## A Few Philosophical Remarks in Parting...

- ❖ Bear in mind that if you are responsible for the company budget you are committing the company to that budget in regard to everyone who sees that budget – from employees to shareholders and financing institutes.
- ❖ The BUDGET is the anchor the company casts into unknown depths.
- ❖ The BUDGET is the measuring stick for the actual company performance.
- ❖ If you err, it is wise to err on the side of caution.
- ❖ A company's performance looks so much better if it outperforms the budget than if it falls woefully short. That holds for the company employees as well: performance is always better when people know they are meeting or even exceeding expectations. A sour grapes budget is usually a self-defeating proposition: It cannot be met; therefore it will not be met!

If you are too busy to go through the process outlined above: the following **MagicWorkbooks®** contain ready-made budgets with plenty of graphs:

<b>BusinessPlanner</b>	all companies
<b>HotelbudgetXXL</b>	for the lodging industry

And these **MagicWorkbooks®** contain ready-made reporting workbooks with a strong emphasis on budget to actual comparisons and projections:

Monthly and year-to-date basis:

PriceCalculator	for the production industry
RestaurantBudget	for the food industry
FeeManager	for the service industry
ProfitReporter	all companies, income statement format

Year-end basis:

CompanyEvaluator	all companies, 5 year budget income statement & balance sheet with DCF company value computation
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