How much value does your budget add?

Most companies formally or informally compare actual performance against a "budget." For some companies, the "budget" may consist entirely of last year's actual performance as presented on the financial statements. Some companies annually go through the exercise of preparing a budget for the next fiscal year, and their budget variance analysis consists only of comparing actual period-to-date amounts with budgeted period-to-date amounts.

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Budgets can be a very effective management tool in improving profitability. I am not just talking about monitoring and cutting expenses. Managing expenses may result in short-term profitability improvement, but the real power and return-on-time invested in the budget process comes from using the information you gather to manage the business and make strategic decisions.

A properly designed, flexible, rolling, dynamic budget will provide management with information in areas such as contribution margin (in total and by product), efficiency of labor input and utilization of equipment, which will assist management in making more effective decisions.

HOW DO YOU DESIGN AND USE SUCH A BUDGET?

The first step is to decide which products/services are the most significant for your company. Second, the company needs to make sure that it is capturing accurate cost data in order to generate an accurate contribution margin by product/service. This cost data needs to include materials, labor, and variable and fixed overhead components.

Armed with this knowledge, the company should generate a sales budget. The sales budget should have an overall revenue goal for each month and detail of anticipated product/service mix. This detail needs to outline how the company plans on achieving its revenue and contribution margin budgets.

Next, the company estimates the sales, marketing and other administrative expenses based on past experience and anticipated expenditures. The most important point management needs to focus on is accurately estimating costs that you can influence and control. Do not invest a lot of time and energy on estimating costs that are relatively uncontrollable.

Now that you have developed a budget that is based on a sales forecast with an anticipated mix of products and services at anticipated contribution margins, and you have identified the major controllable expenses, you now can begin the process of using this budget as a tool for managing the business.

The key is to keep the budget a living, dynamic forecasting tool. At the end of each period, the actual product/service revenue mix along with the actual contribution margin should be compared to the budgeted product/service mix and margin. Variances should be identified and, if significant, investigated to see why the product/service mix was different than forecasted.

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The next step is to reset the budget at the contribution margin and operating expense level based on the actual product/service mix. The benefit of resetting the budget is you can identify the true favorable and unfavorable variances associated with materials, labor, variable and fixed overhead. If you do not reset the budget with actual sales mix, the variances may be distorted and not give management a true indication of how well the company is actually performing.

Many management teams begin with a 12- to 24-month budget. As each month closes, the current budget period is replaced with actual results, the next three- to six-month periods are reset based on expected changes in product/service mix, contribution margins, etc.

The process of resetting the near-term budget periods allows management the opportunity to use information obtained from the recent past, along with information from the sales team, to generate a more accurate, expected-results budget. The periods in the budget longer than three to six months out are more representative of a forecast for a possible long-term outcome.

As you can see, management can create a budgeting system that focuses on product/service mix, contribution margin, and controllable costs, and use the information as a living, dynamic management tool. You then will have access to information beyond traditional budget variance analysis. This can be used for making decisions that can help focus the efforts of various departments and result in more effective management. PM

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