Managing Budgets

MTD Training

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Preface

Managing a budget can be a very challenging activity! There are always pressures on expenditure and in today's economic climate there is the need to "do more for less" in terms of costs are concerned.
In this textbook you'll receive a thorough grounding in terms of what budgets are and how you can manage them effectively. We'll cover how to monitor the costs and how to forecast what you need on an ongoing basis.

Sean McPheat, the Founder and Managing Director of management development specialists, MTD Training is the author of this publication. Sean has been featured on CNN, BBC, ITV, on numerous radio stations and has contributed to many newspapers. He's been featured in over 250 different publications as a thought leader within the management development and training industry.

MTD has been working with a **wide variety of clients** (both large and small) in the UK and internationally for several years.

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- In-house, tailor made management training courses (1-5 days duration)
- Open courses (Delivered throughout the UK at various locations)
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Our programmes are delivered when and where you need them! We believe that training should be fun, highly interactive and provide "real world" practical techniques and methods that you can use back in the office – and that's exactly what we provide.

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Contact MTD:

Online:
Web: www.m-t-d.co.uk
Email: info@m-t-d.co.uk

Telephone:
From The UK: 0800 849 6732
International: ++ 44 2476 233 151

1. Introduction

Every organization has a budget and a budget process. In fact, many of them have more than one type of budget. All budgets are a type of plan or guide that is based on the fact that your organization has goals that it wants to meet. For example, your organization might want to:

- Launch a new product
- Open a new office
- Expand into another area
- Increase its customer base
- Upgrade its technology

And in pursuing these goals, it will also want to maintain its current position. So you have to budget for continuing operations as they are in addition to whatever else you plan to reach for.

When you are responsible for managing a budget, there could be several ways in which this responsibility affects your work. In any management position:

- You must remain aware of what you are spending and what type of spending it is
- You must pay attention to what the limits on your spending are in each category
- You will need to watch the budget for any areas of concern, such as running out of money in a fund before the budget year is over
- Whether or not you need to make a request for additional

If you are responsible for generating revenues, then you also want to pay attention to:

- How well the revenues you are generating are correlating with the revenues that you are budgeted to earn in a given year
- Whether or not you have the resources you need to generate that revenue

1.2 Overview of the Ebook

As we look at what's important in budgeting, we'll also look at some information that will help you get a full picture of the organization's finances. In this ebook, we'll look at:

- The budget as a policy statement – what the budget is telling you about an organization
- Financial information related to the budget – the budget is a document that is created 'in the past' – at least for most of the time that you look at it. There are other important financial documents that, when compared to the budget, will help you understand how the organization is doing financially
- How to read and understand a budget – we'll examine the information that the budget gives you as well as the questions that the information might set up in your mind
- How to approach budgeting for your projects – what you need to consider, what some of the constraints might be, and how you can make sure that you have the resources you need to complete your objectives

1.3 Basic Finance Terms

Budgets and discussions about finance use a certain "lingo." In order to help you understand what is explained in the rest of the ebook, you should have some basic terms under your belt. Figure 1 lists some of the most commonly used terms in corporate finance.

Assets	Items owned by the business (see Capital Assets, Current Assets and Fixed Assets)
Capital	Assets available to be invested with the intention of creating new assets.
Capital Assets	Tangible property that is not easily converted into cash. Capital assets are usually held long-term and include things like buildings, equipment, and other owned items.

Current Assets	The company's total of cash, accounts receivable, and other assets that could be converted into cash within a year. This is the money usually used for day-to-day operations.
Debt Financing	Creating capital by incurring debt such as by selling bonds or notes.
Equity	1) The total of a company's assets minus its liabilities 2) Ownership interest in a corporation in the form of stock
Expenses	Any cost of operating the business
Fixed Assets	Long-term, tangible assets that are used by the business tnd that the organization does not plan to convert to cash in the current or next fiscal year.
Liabilities	A financial obligation such as debts, claims, or losses
Operating Budget	A projection of estimated income and expenses during a specific period. An operating budget is short-term, usually for one year, while a capital budget is long-term.
Revenue	Income generated as part of the operations of the organization before liabilities are subtracted.

Figure 1: Basic Finance Terms

2. The Budget as a Policy Statement

2.1 Introduction

A budget may be a guideline regarding your expenses and revenues, but it is more than that. It is actually a policy statement that your organization is issuing. It gives the reader insight into the organization, how it operates, and what is important to that organization.

> A budget is actually a policy statement that your organization is issuing regarding its values and goals.

Think for a moment about your own budget. Where do you spend your money? What does that say about you? For example, do you value education enough to pay for it for your children? Do you value your car enough to keep a car payment? Or do you value security more so you actually invest a great deal in savings? Your personal budget would tell an observer information about you, just as an organization's budget will tell you a great deal about an organization. In this chapter we'll examine what the budget tells you about an organization and its policies.

2.2 Organizational Structure and Operations

One of the first things you can determine from a budget is how the company is organized, and you can also get some indication of how the organization operates. For example, you can determine:

- What departments exist
- How those departments are sub-divided, which hints at reporting relationships
- From personnel expenses, the approximate size of each team
- What the organization's objectives might be for each team
- How the organization uses human resources. For example, do they budget a great deal of money for contract labor? What about overtime?
- Does the organization provide its own in-house services like technical support, or might it need to hire outside technical assistance?

2.3 Organizational Values

The budget document, when read closely, can also tell you a great deal about what an organization values. In other words, where does the organization invest? What does it spend money on liberally and where does it restrict spending? Specifically, you might look for value information by asking yourself questions about the budget like:

- How much does the organization pay its employees?
- How much money is budgeted for benefits and retirement plans?
- Does the organization value training and developing its employees?
- What about new research and development or marketing?
- What about technology upgrades and improvements?
- Is any money budgeted for community outreach or community support?
- Does the company value diversity and inclusiveness by paying for marketing and support materials in multiple languages?

- How much money is dedicated to customer support and assistance?
- Would I want to be a customer of this organization based on what I see?

2.4 Organizational Direction

The budget document can also give you information on where the organization is heading – or at least where they hope to be heading. It does so by telling you where they are investing their money. Are they:

- Creating a new intitiative? What kind?
- Launching a new product?
- Entering a new market segment?
- Expanding?
- Consolidating?
- Investing in higher technology?

If you can determine where an organization is investing its resources, you can learn a lot about what is important to its leadership.

2.5 Debt and Debt Servicing

Like in your own personal budget, the amount of debt that is listed in an organization's budget will tell you about the decisions the organization has made in the past. You may also be able to glean from the amount of debt what strain that debt is placing on the organization's health. For example:

- Are they paying more in debt than they are making in revenue?
- What was the debt taken on for?
- Does the investment seem to be paying off?
- How much of the organization's resources are not going to debt payments, and for how much longer?

- What does this tell you about the organization's decision-making in the past?

It has been said that the best prediction of future behavior is past behavior. So if the organization has a habit of operating while in significant debt, what does that say about how they might operate in the future?

2.6 Where the Organization Might Be Weakest

Since the organization's budget provides you with insight into where it has placed its priorities, that knowledge can also help you to understand where the organization might have problems reaching its objectives. If you have ever been in the position of having your budget cut, then you have experienced what it's like to struggle to meet your objectives. So, what does the budget tell you about where the organization might have weaknesses?

- Start by looking at your own division's budget. Where is it tight? Where have you had to move money around in order to meet your objectives?

- In the organization's budget, where are the weak points? Where do you see the potential for the employees in an area to struggle to meet their objectives with the budgeted amounts they have been allocated?
- What areas are neglected in the budget? For example, has the organization provided funding for upgrading existing infrastructure? For keeping up with the latest technology changes?

- Is the organization investing enough in its people, or do you see that turnover might occur because of lack of benefits, lack of development, or lack of sufficient financial compensation?

2.7 Where the Organization is Strongest

Along the same vein, the organization's budget will give you information about where its strengths are. These should be the areas of operations in which the organization has a competitive advantage as well.

3. Financial Information Related to the Budget

3.1 Introduction

The budget is a written description of an organization's best laid prediction of its future. But throughout the year, the budget is analyzed in relation to other financial reports that provide important information. Since the goal of all businesses is to maximize profits, the management team needs information to help them navigate financial decisions. All businesses produce financial statements that provide different information about the organization's financial health. This information can help you to compare what the organization predicted would happen to what is actually happening. That information is used by the senior managers to make important decisions regarding the organization's future. The three main financial statements that are produced in addition to the budget are:

> All businesses produce financial statements that provide different information about the organization's financial health.

- The Balance Sheet (also called a Statement of Financial Condition or Statement of Financial Position)
- The Income Statement (also called a Profit and Loss Statement, Statement of Operations, or Statement of Earnings)
- The Cash Flow Statement

If you are a manager, you will want to be familiar with these documents so that you can read and interpret the information. Then you can compare the information to the budget as a means of determining how you are doing in operating your own division or department. In the following chapters, we'll look at each of these statements individually to understand:

- How the statement is created
- How to read the statement
- What the statement tells you, and just as importantly –
- What the statement does not tell you

However, none of these financial statements can be created without information from your organization's accounting or bookkeeping information. In fact, you cannot read the budget completely until you have a basic understanding of certain aspects of accounting, particularly the Chart of Accounts.

3.2 Bookkeeping and the Budget

Bookkeeping is the act of keeping up with the changes in an organization's accounts. Every time your organization performs a transaction of any kind, the accounts (books) change. While these changes are not reflected in the budget, they do affect the budget because you might need to make adjustments to where your funds are allocated depending on what changes have occurred.

For example, imagine you operate a retail establishment. If you find that your budget for the month called for $1,000 in marketing but you spent $1,500, you will need to adjust the accounts in some format in order to accommodate that extra $500 spent. But the accounts are also adjusted for other transactions. So, every time you make a sale, the inventory of that item or items decreases and the amount of your cash increases. Various ledgers and journals are used to track these changes. Those ledgers and journals are then used to create the financial statements listed above.

While these changes are not reflected in the budget, they do affect the budget because you might need to make adjustments to where your funds are allocated.

Accounting has one very fundamental equation:

$$\text{Total Assets} = \text{Total Liabilities} + \text{Equity}$$

In other words, what the company has in value is the difference between what they own and what they owe. It works the same for you as an individual. Your net worth is the total of your assets minus any debt that you owe. For a business, there are usually just more assets and liabilities to calculate.

To see this more easily, just rewrite the equation as:

Equity = Total Assets – Total Liabilities

In either version of the equation, what will happen when a transaction occurs? At least two of the factors will change for any transaction. So, for example, if your equity increases, your assets must have increased or your liabilities must have decreased – or both. Accounting is the process of tracking all of these changes in the financial equation. The accountant or bookkeeper must then be able to record the information and report the information in ways that are helpful for those that are making decisions about the operations and direction of the organization. In one view, you could say that the budget is a prediction of how the sum total of these changes will occur over the budget year, and the financial reports you create during the year tell you how on-target your predictions were.

In one view, you could say that the budget is a prediction of how the sum total of these changes will occur over the budget year, and the financial reports you create during the year tell you how on-target your predictions were.

3.3 Chart of Accounts

The tool used to track the changes described above is the Chart of Accounts. A business has specific accounts within their chart which correspond to the assets and liabilities that the organization has. For example, some accounts in the chart of accounts for a temporary agency might be:

- Assets:
    - Cash
    - Accounts Receivable
    - Equipment

- Liabilities:
    - Salaries
    - Benefits
    - Advertising
    - Accounts Payable

However, there are usually dozens – if not hundreds – of accounts under both assets and liabilities. It depends on how the organization tracks all of their finances. For example, if you work for a large corporation with multiple departments, you will have more accounts in your Chart of Accounts than if you are a one-man consulting firm.

In conventional accounting, all of the accounts the company uses are grouped together by like categories and then are numbered according to a standard format. The conventional numbering system is:

- Assets 101 – 199
- Liabilities 200 – 299
- Equity 300 – 399
- Revenue 400 – 499
- Expenses 500 – 599

Some organizations might use 600s for expenses. And an organization can also add account identifiers to further subdivide an account. For example, you could have an expense account 501 for “utilities” and add identifiers for each utility so that it might look like this:

- 501001 – Gas
- 501002 – Power
- 501003 – Water
- 501004 – Waste Disposal

Or, an organization with multiple departments that also budgets and tracks expenses by departments could use sub-identifiers to denote an expense for each department. So, for example, perhaps all utilities for the organization start with a 501, then all the Marketing department utility expenses add a sub-identifier of 001, followed by another sub-identifier to denote the actual expense. So, let's imagine you're looking at all the charges for waste disposal across multiple locations. It could look like this:

- Marketing: 501004-001
- IT: 501004-002
- Training: 501004-003

Another way of dividing the chart of accounts is to have the first part of the account number identify the source of the fund that is used to pay for the expense or the destination fund of where the revenue will be going. You see this when an organization has regulations that limit or define how revenue needs to be used. For example, if your organization has received a government grant, you may have to use that grant only for specific activities. You can use your chart of accounts to help you track the expenses you use that grant money for, which will make your life easier if you have to demonstrate your use of the grant funds.

When you examine your budget, you will also see that the Chart of Accounts is used to differentiate between the different funds listed on the document. When referring to the budget, you will hear each account number called a 'line item.'

3.4 The General Journal (Original Book of Entry)

The General Journal is used to record daily transactions that occur. Today, this is usually done electronically with financial software, but of course it used to be done in a large written journal. In order to record transactions correctly, you need to know the rules accountants use called "transaction analysis." The two rules are:

- Asset and Expense accounts increase with a debit and decrease with a credit.
- Liability, Equity, and Revenue accounts increase with a credit and decrease with a debit.

The first rule will sound counter-intuitive, but it's because there is a corresponding entry made that will 'balance out' the accounts. You may have heard this process referred to as 'double-entry' bookkeeping. To understand the process, imagine that you purchase a computer with $600 in cash and $1200 store credit. An example of a General Journal entry for this transaction is shown in Figure 2.

Notice that the purchase of one item required an entry for three different accounts. You can see the name of each account under "description" and the number of the account under column 'F.' The General Journal is kept in chronological order, which can be very helpful if you need to look back over the history of your transactions.

However, there is one glaring piece of information that is missing on the General Journal. You don't see any information about the balance in each account that you have impacted. For example, just by looking at the General Journal, you don't have any idea how much cash you have left after the purchase of the computer. To track the changes in account balances, your accounting team uses a General Ledger.

FY20XX		Description	F	Debit	Credit
Nov	22	Equipment	144	1,800	
		Cash	101		600
		Accounts Payable	200		1,200
		Purchase of Computer with $600 cash and $1200 store credit			

Figure 2: Example of General Journal Entry

3.5 The General Ledger

The General Ledger is organized by ledger accounts. There is one ledger account for each account in your Chart of Accounts. The accountant will take the information from the General Journal and post it to each of the General Ledger accounts that were affected by the transaction. Again, this is normally done electronically today, with software that automatically posts to the ledger accounts each time you enter a transaction in the General Journal. But just to be sure you understand how the information is posted, let's look at an example of how we would post to the ledger accounts from the General Journal entry in our example from Figure 2 again.

FY20XX		Description	F	Debit	Credit
Nov	22	Equipment	144	1,800	
		Cash	101		600
		Accounts Payable	200		1,200
		Purchase of Computer with $600 cash and $1200 store credit			

You're going to want to post to three accounts:

- Equipment (144)
- Cash (101)
- Accounts Payable (200)

Figure 3 shows the three entries you would make in the General Ledger.

GENERAL LEDGER
Equipment Account #144

FY20XX		Description	F	Debit	Credit	Balance
Oct	31					4,200
Nov	22	Computer	J2	1,800		6,000

GENERAL LEDGER
Cash Account #101

FY20XX		Description	F	Debit	Credit	Balance
Oct	31					3,700
Nov	22	Computer	J2		600	3,100

GENERAL LEDGER
Accounts Payable Account #200

FY20XX		Description	F	Debit	Credit	Balance
Oct	31					800
Nov	22	Computer	J2		1,800	2,600

Figure 3: Examples of General Ledger Account Entries

To read the entries, here is an interpretation of the information:

- The first entry in each ledger shows the balance from the previous month
- In Colum F, the reference is to the page in the General Journal (J for Journal, 2 for the page number) where the item was recorded.

Now that the information is posted, the financial statements that need the information can be prepared. You can also prepare an updated budget because you know what amount remains in each line item. We'll look at this information in more detail after examining the other related financial reports.

4. Balance Sheet

4.1 Introduction

Now you've seen how the day-to-day recording of transactional information is recorded. But how do you put it into a format that can help you see the financial state of the organization? Can you just look at the budget and what has been spent in each category to this point in the year compared to what was intended to be spent? That's one way to do it, but there's an easier way - this is where the Balance Sheet comes in. It is a 'snapshot' of the finances of the business at one given time. The information given includes what the business owns and what it owes.

There are three sections to the Balance Sheet:

- Assets – the items of value owned by the company
- Liabilities – the company's obligations, whether to pay for or provide goods or services at a future date
- Equity – remembering our equation from Chapter 2, equity is the amount of net assets (assets – liabilities)

A Balance Sheet gets its name from the fact that the total of the assets listed must equal the total of the liabilities and equity – in other words, the two sides of the sheet must balance. For an example of a Balance Sheet, see Figure 4. It's a relatively simple example, since most businesses will have many more accounts under their assets, liabilities, and equity categories on their Chart of Accounts. But you can get the basic idea for how the information is shared via the Balance Sheet.

4.2 What a Balance Sheet Tells You

There is good information on the Balance Sheet, such as:

- A summary of the organization's assets and the claims against those assets as of a specific date.
- Information about the organization's current ability to pay its current debts. You can only tell at the moment, for the liabilities that the accounting team has already entered into the financial system. If a large liability were to be incurred tomorrow, the financial picture could shift significantly.
- The information shows how the organization is positioned to keep going with the day to day business operations. For example, the assets listed give you some idea of what you have available right now to keep trying to generate new assets (new revenue).

- The Balance Sheet also shows what claim the owners have against the business' assets. Of course, this is conditional on the other liabilities being satisfied.

ABC Enterprises				
Balance Sheet				
As of November 30, 20XX				
Assets		**Liabilities**		
Cash	8,500	Bank Loan	5,000	
Inventory	14,000	Accounts Payable	1,200	
Accounts Receivable	2,200	Total Liabilities		6,200
Equipment	4,600			
		Equity		
		Paid in Capital	15,000	
		Retained Earnings	8,100	
		Total Equity		23,100
Total Assets	**29,300**	**Total Liabilities & Equity**		**29,300**

Figure 4: Sample Balance Sheet

4.3 What the Balance Sheet Doesn't Tell You

Of course, there are several parts of the financial picture that are not included in the Balance Sheet. For example, the Balance Sheet does not tell you:

- How any profits were made. For that information, you'd need to look at the Income Statement.
- Which assets creditors have claims against. For example, if you are financing equipment, your creditor has a claim against that equipment until it is paid.
- What kind of capital investment was made. You might assume that we're talking about cash, but instead, the owner or owners might have purchased a building that is not necessarily convertible back to cash (at least not immediately).
- What value the business would have on the market place. For example, if the owner purchased that building for $50,000 10 years ago, it might be worth twice that now. Or, it could even be worth less if the real estate market has suffered since then.

- Where each line item on the budget is in comparison to what you budgeted for it. For example, if you want to know how much you've spent on employee training at this point in the year and whether or not you have enough left in the account to send an employee to a conference, you'd need to look at the ledger account for training, or at a year-to-date view of the budget.

5. The Income Statement

5.1 Introduction

During the fiscal year, any organization will have changes in its finances. The changes could be positive or they could be negative. But the senior management of an organization will want to know the answers to questions like:

- How well are we doing financially?
- Are we earning a profit?
- Are we running at a loss?
- How is our profit in comparison to the competition?
- Are we likely to continue earning profit?

The budget might give you a clue to some of these questions, because if you see that the amount spent on every line item is so high that you're about to exhaust your funds, that's a bad sign. But to answer these and similar questions, you can get better information from an Income Statement.

5.2 Elements of the Income Statement

Whereas the Balance Sheet offers a snapshot of an organization's finances at one given point in time, the Income Statement looks at incoming revenue and outgoing expenses over a period of time. For the Income Statement we use the following definitions:

- Revenue – incoming assets in return for sold goods or services (cash or accounts receivable, for example).
- Expenses – outgoing assets or liabilities incurred (accounts payable, inventory sold or supplies used, for example).
- Net Income – the difference between Revenue and Expenses

With all of this information, the Balance Sheet shows you whether you are generating a profit or you are operating at a loss. For an example of a Balance Sheet, see Figure 5.

Widget Works, Inc.		
Income Statement		
For the Month Ended February 28, 20XX		
Revenue		
Sales Revenue	9,700	
Consulting Revenue	2,000	
Investment Revenue	550	
Expenses		
Salaries	3,800	
Benefits	400	
Rent	800	
Utilities	325	
Supplies	675	
Inventory	2,000	
Depreciation	875	

Total Expenses	8875	
Net Income	$3,375	

Figure 5: The Income Statement

The bottom figure on the chart in Figure 5 is the Net Income. This is the difference between the organization's assets and its liabilities. It is the amount by which the equity of the organization increases or decreases in a given period. This amount would also be recorded in an equity account, also called a Retained Earnings account, depending on the type of organization yours is. This takes us back to the Balance Sheet. Remember the sample Balance Sheet created for ABC Enterprises in the last chapter? Here it is again. Notice where the Retained Earnings amount is listed.

ABC Enterprises				
Balance Sheet				
As of November 30, 20XX				
Assets		**Liabilities**		
Cash	8,500	Bank Loan	5,000	
Inventory	14,000	Accounts Payable	1,200	
Accounts Receivable	2,200	Total Liabilities		6,200
Equipment	4,600			
		Equity		
		Paid in Capital	15,000	
		Retained Earnings	8,100	
		Total Equity		23,100
Total Assets	**29,300**	**Total Liabilities & Equity**		**29,300**

It's important to realize that just because the organization has a positive Net Income for the month, that doesn't mean that they have that amount in cash available. Income can include more than just cash, such as interest earned from investments or financing could also be included as Retained Earnings. In order to know exactly what cash is still available at the end of the month, you would create a Cash Flow Statement. We'll look at how to do that in the next chapter.

5.3 What an Income Statement Tells You

The income statement tells you:

- The main sources of income earned
- Secondary sources of income earned
- Some information about the organization based on the categories of revenue that are listed. For example, "Sales Revenue" tells you that the organization sells a product or service, while "Fees Earned" would tell you that the organization is a professional service provider of some kind.
- What items have no value left for the company because they are expenses – they will not generate any new income for the organization
- Whether or not the organization is operating with a loss or if they are operating with balanced revenues and expenses

5.4 What an Income Statement Does Not Tell You

We've already mentioned in our discussion of Income Statements some of the things that it does not tell you. But here is a full list. An income statement does not tell you:

- Any prediction for future net income. The Income Statement is a historical document in the sense that it tells you what has already happened. It cannot be relied upon as a predictor of what will happen in future accounting periods.

- The exact amount of net income that was generated during the period the Income Statement covers. Even if the statement is very well prepared by the best accountants, it is impossible to accurately account for everything. For example, imagine that you spend $2,000 on a telephone marketing campaign to tell your clients or customers about an upcoming special you are offering. If you generate $8,000 in sales the next month, you cannot say that the marketing campaign generated that $8,000 in total. You may have some customers who would have come to you anyway – who might not have even seen the advertisement. Or, you might have customers that received the advertisement, but didn't buy from you until the second or third month after the advertisement. The revenue for those sales would be attributed to the months in which they occurred, even if it was generated by efforts made several months before.

- Actual profit. Since revenues are not able to be fully, accurately reported in the accounting period, neither can profit be calculated to 100 percent accuracy. Plus, you also can't calculate what is called True Profit. This is the difference between what expenses the organization has incurred and what assets have been invested

- The amount of cash on hand. As we mentioned before, Net Income does not mean cash. It only means the excess revenue over expenses in a specific period. Remember that incoming cash could be used for more investments or to buy more assets, or it could actually be received in a month other than when it was generated.

6. Cash Flow Statement

6.1 Introduction

The Cash Flow Statement is where we track cash coming into and going out of the business. Again, this is done for a specific period of time. To understand the Cash Flow Statement, we first need to introduce a few more finance terms.

- **Cash-based accounting**

  In cash-based accounting, all transactions are recorded when the cash is actually received or spent. You would include payments or received funds in the form of cash, check credit card payments, debit card payments, electronic transfers, or any other means of payment. For tracking cash-flow, this is the easier of the two accounting systems.

- **Accrual-based accounting**

  With accrual-based accounting, you record all transactions when they occur, even if no cash has changed hands. For example, if you were to sell something to a customer on store credit, you would give the customer the product immediately, but you wouldn't receive payment for the item until they make it at a later date. This system is not good for tracking actual cash flow. For example, you could make thousands of dollars of sales so that you have a great deal of money showing as revenue on your Income Statement, but you could have zero dollars in the bank! If your organization uses accrual-based accounting, creating the Cash Flow Statement is more complicated. It will require that you look at your Net Income and determine what portion of it was actually cash. Then you will have to add and sub out the changes in accounts that do not have an impact on cash, such as depreciation.

- **Depreciation**

  Considered a non-cash expense, depreciation is the reduction in value of an asset that occurs over time. Depreciation could be due from use, wearh and taear, age, or irrelevance. For example, the computer you buy today will not be worth what you paid for it in five years. Instead, it will gradually depreciate until it either reaches the end of its life or it becomes completely useless for the operation of the business. Depreciation has to be included in financial statements as a cost in order to represent the true value of the organization's assets.

6.2 Cash Flow Categories

The Cash Flow Statement typically analyzes cash flow in three different categories:

- Operations
- Financing
- Investing

Figure 6 demonstrates the main sources of incoming cash and the common uses for cash income.

Forms of Cash	Common Use(s) of Cash
Operations	Cash Dividends
New loans	Loan Repayment
New stock issues or owner investment	Stock repurchase
Property or equipment sale	Property or equipment purchase
Sale of capital or long-term asset	Purchase of capital or long-term asset

Figure 6: Sources and Uses of Cash Income

6.3 Preparing the Cash Flow Statement

To prepare the Cash Flow Statement, you will need to look at the difference between the Balance Sheets from the beginning and the end of the accounting period. You will also need to look at the Net Income from the same period. Table 7 shows a sample of a Cash Flow Statement with a twist – the fourth column tells you where the information came from.

AnyCom			
Statement of Cash Flow			
For the month ending January, 20XX			
Cash Flow from Operations			
Net Income	$6,700		Both from the Income Statement
Depreciation	250		
Increase in Accounts Receivable	-400		From the differences between the December and January Balance Sheets
Decrease in Inventory	1,500		
Decrease in Accounts Payable	-625		
Net Cash Flow from Operations		$7,425	
Cash Flow from Investing			The difference between the equipment entry in December 31 and January 31 minus equipment depreciation for the month. The negative entry indicates an equipment purchase of $2,200.
Equipment Purchase	-$2,200		
Net Cash Flow from Investing		-$2,200	

Cash Flow from Financing			From the difference between the December and January Balance Sheets
Loan Payments	-$800		
Net Cash Flow from Financing		-$800	
Net Increase (Decrease) in Cash		$1,200	
Cash in the Beginning of Period		$4,400	
Cash at the End of the Period		$6,600	Equals the amount on the January 31st Balance Sheet

Figure 7: Sample Cash Flow Statement with Information on Source

The amount given for the increase in cash is, at least partly, due to the conversion of accrual accounts into actual cash value.

At this point, you should be able to understand where the amounts in the financial statements come from and how to read the statements. However, you should also realize that it can take years to learn and fully understand accounting and bookkeeping processes. As you get more practice reading (and possibly creating) these statements, you will find it easier to do. Luckily, you don't have to fully understand accounting and bookkeeping in order to read and understand a standard budget format.

7. Understanding Budgets

7.1 Introduction

A budget is a plan that normally covers one year, called a Fiscal Year. In many organizations, the Fiscal Year is from July to June. In others, it may be the calendar year. Organizations choose their Fiscal Year cycle for different reasons. The organization may take advantage of government funding that requires reporting in a certain time frame so that it's easier to run their budget around that time frame. Or, there could be market reasons for choosing a particular Fiscal Year. The Fiscal Year will be referred to as FYXX. For example, a budget running from July, 2010 to June, 2011 will be called FY11, even though part of the budget year is in 2010. A calendar year budget, say from January, 2011 to December, 2011 will also be called FY11.

Organizations approach the process of budgeting differently, depending on the type and size of the organization. For example, a public government budget might require a vote. A large corporation's annual budget may also require a vote. But however the budget gets adopted, it normally starts in one of three ways.

7.2 Reading the Budget

As we said, a budget provides information on planned expenses and revenues over a given time period, usually one year. A simple sample budget is provided in Figure 8. As you read the budget, you will see that:

- It is broken into categories corresponding to your Chart of Accounts. Each account will be represented by a line or lines on the budget, which is why they are called "budget line items."
- There is a column for the amounts that were budgeted for each line item
- There is a column for the amounts that were actually spent (or earned) for each line item
- It might show the previous years' budget information for each line item
- It might show the predicted budget amount for the next fiscal year (or two)

XYZ Co.
FY11 Operating Budget
November, 2010

	FY10 Actual	FY11 Budget	FY11 Projected Actual	FY11 YTD
Income:				
Sales	$256,456	$278,000	$269,000	$109,000
Fees	$17,890	$21,000	$23,500	$10,090
Interest	$3,200	$4,800	$4,020	$1,876
Other	$225	$300	$280	$107
Total Income:	$277,771	$304,100	$296,800	$121,073
Reserves	$160,000	$178,000	$168,000	$162,000
Total Operating Income:	$437,771	$482,100	$464,800	$283,073
Operating Expenses:				
Salaries	$137,000	$156,000	$148,000	$65,000
Benefits	$13,700	$15,600	$14,800	$6,500
Office Rent	$12,000	$12,600	$12,600	$5,250
Utilties	$4,875	$5,200	$5,200	$2,167
Insurance	$1200	$1,440	$1,440	$1,440
Marketing	$8,000	$10,000	$12,000	$7,500
Total Operating Expenses:	$176,775	$200,840	$194,040	$87,857

Figure 8: Sample Budget

Note that in Figure 8, the Chart of Accounts numbers were left out for convenience, but normally they would be listed in numerical order down the first left-hand column. In some budgets, there might also be a final column called "budget deviation." This is the percent difference between where you planned to be versus where you are. However, before we calculate deviation, let's take a look at what information the budget in Figure 8 gives us, as well as what questions it might lead us to ask.

7.2.1 Information Given

The sample budget in Figure 8 is a simple one. It doesn't list as many accounts as you would expect a business to have. However, it will suffice for our discussion. Let's assume that this business has a fiscal year that runs from July, 2010 to June, 2011. The sample budget gives us:

- The dollar amounts that were actually spent for each line item in FY10 (the previous fiscal year)
- The dollar amounts budgeted for each line item when the budget was adopted for FY11
- At this point in the fiscal year, the actual amount we believe will be earned or spent by the end of the fiscal year for each line item

- At this point in the fiscal year, how much has actually been spent

With a bit more analysis, we can also figure out:

- If we are on-target as far as where we should be in the year for revenues
- If our estimates of where our expenses should be were accurate
- Where we might have some concerns because we are not on-target

7.2.2 Questions We Might Ask

Now let's take a closer look at what the information in the budget might prompt us to ask about what is going on in the business. For example, on the income side:

- Our FY11 projected actual for sales is lower than what we budgeted for the year. What has happened that accounts for the difference? Do we need to ramp up marketing efforts? Is there a sale or event that we need to have in order to up the sales to where we need them to be? What would these decisions do to our budgeted marketing expenses?
- The projected fees for the year are above where we needed to be for the budget to be met. Does that mean we can relax a bit about not having met the sales goal for this year so far? Does having a different mix of revenues than we budgeted for have an impact on any other operating costs? For example, if fees come from intensive one-on-one consulting, we might have to pay for high-level consultants at a cost we weren't counting on.
- Let's assume that our interest income is down from where we budgeted because of the economy. Is that a sign that we might face other revenue difficulties? Do we need to adjust our investment strategy?
- Why aren't the reserves at the point where we thought they would be by this time in the year? Have we had unexpected expenses?

On the expenses side, we can see that there are some fixed costs that we budgeted accurately because of the fact that we knew the amount wouldn't change during the year. Of course, this assumes that items like rent, utilities, and insurance payments would be the same every month. You can tell we have several fixed expenses by noticing that:

Office rent of $12,600 / 12 months = $1,050 per month

In November, the fifth month, our Year-to-Date amount should be
5 x $1,050, or $5,250

Utilities of $5,200 / 12 months = $433.33 per month

In November, the fifth month, our Year-to-Date amount should be
5 x $433.33, rounded up to $2,167

In both cases, we see that these are indeed fixed expenses.

Now take a look at the budgeted amount for insurance. Since we budgeted $1,440, which is the same as the projected actual and the Year-to-Date amount, we can assume that the insurance payment is made once per year and that it has already been made for the year.

There are also some questions to wonder about as well, such as:

- Why has the projection for salaries decreased from the budgeted amount? Perhaps someone is under-performing. Or perhaps you've had a vacancy for a time so that you haven't spent all of your budgeted salary dollars.

- For benefits, the same question could apply. Note that for simplicity, benefits were budgeted in the example at a flat 10% of the salary numbers. But that won't always be the case. For example, if someone were out on leave, the benefits amount paid could remain as predicted even if the salary amount were reduced.

- Marketing is not a fixed expense, since if it were we would see just $5,000 spent by this time of year ($12,000 / 12 = $1,000, multiply that by five for the fifth month and you would get $5,000). What does that do to the rest of the year's marketing plans? Especially given that our sales figure isn't where we wanted it to be for this time of year?

7.2.3 Budget Deviation

What we've been doing in the last two sections is a form of budget deviation analysis. Budget deviation is important because it helps you to identify areas of potential concern. The larger the deviation, and for the longer amount of time that it happens, the more you need to reevaluate your budget.

8. Budgeting Your Project(s)

8.1 Introduction

When you have to create a budget, there are several steps to doing it well. Some of these steps might be prescribed by your organization's Finance Department, so you might not have a choice in how you proceed. But if you do, the first thing to consider is which approach to budgeting you will use. Then you'll need to realistically evaluate the project's objectives, how you will achieve them, and what you will need to do so.

8.2 Approaches to Budgeting

You may be required to develop and submit a budget proposal for your own department or division. When you are determining how to create your budget, there are three common practices:

1. Take last year's budget and, depending on orders or your subjective view of the year to come, either add to it or cut from it to arrive at a satisfactory budget for the new year. This is a rather random method, since it is not informed by what you hope to achieve in the coming year as far as the growth of your organization.

2. Use the coming year's predicted sales as the basis for the budget. In this case, the organization may have already determined that your division receives a set percentage of the sales goal for the year. However, doing so means that the organization is relatively confident that its sales predictions are correct. If you are basing them on last year, and last year was a slow year, then you might end up with less funds than you need in order to keep up with the sales that actually occur. If last year was a banner year, then you might end up with more budgeted costs than actual sales. In either case, the accurate prediction of your future sales is important for using this method.

3. The third common method is called 'blank-page' budgeting. This is usually considered to be the best approach by budget professionals because it allows you to start from scratch and use your identified objectives and priorities as the basis for the budget you create. In this scenario, you look at the coming the year's objectives and then you examine what you will need in your budget in order to achieve those objectives.

No matter what method you choose, you will probably have to propose your budget to management in order to get approval. It is a good idea to give management a few options. So you should create a minimum budget, a target budget, and a stretch budget.

8.2.1 Minimum Budget

This is the bare essentials, rock-bottom amount that you can see being required to achieve the lowest level of your objectives. It's important that you truly define what you will be able to do with this budget, and more importantly, what you will NOT be able to do. This makes it clear to management what level of risk they are taking if they only agree to fund your budget at the minimum level.

8.2.2 Target Budget

This is the level of a budget that you feel is the bare minimum in order to fully support the established objectives for the coming year. You are saying with this budget that you can commit to helping achieve the stated objectives as long as you have this amount of funding. Again, you need to clearly delineate what you would be able to provide at this level. Make it realistic, achievable, and as accurate as possible because if you get the full target budget, you will be held to what you have promised.

8.2.3 Stretch Budget

In this funding scenario, you are itemizing what additional level of objectives you can meet if you have this higher level of budget. Don't be surprised if you do not receive this level of budgeting – it's entirely possible that the rest of the organization simply couldn't handle a higher level of performance than what the stated objectives will provide. For example, if you stated that you could increase sales by 10% with your stretch budget, that would mean that everyone involved in supporting the sales team would need to be able to handle that additional 10% of customers, as would customer service, shipping and delivery, or any other departments that interact with customers.

8.3 Budget Objectives

In order to define objectives, start by asking yourself the questions below regarding your overall goals:

- What are we trying to achieve?
- By when are we aiming to achieve it?
- Will this project be completed in one fiscal year or will it span several?
- What, specifically, are the goals, and why are they important to the organization?
- What will success look like?

In any project, there are objectives that must be met in order for a project to be successful. If you don't meet them, the project will be considered a failure even if you meet certain other objectives. These essential objectives are the Key Success Criteria (KSC).

Identifying your KSCs is important because they serve as the minimum requirements that you must budget for. Since things can change quickly in an organization, your project could be changed while you're working on it: budgets could get cut, structures could be reorganized, or the market in which you operate could shift in an unforeseen way.

8.4 Budget Constraints

Every project and every budget will have some form of constraints, simply because of the fact that our resources are finite and our willingness to expose ourselves to risk is limited as well. Whereas we might want to spend two years researching our new product idea, testing it, and getting it to the marketplace, we may not be able to spend that much money for research and testing. You will have budget constraints in one or more of the following areas:

- Resources
- Performance Criteria
- Time
- Risk

8.4.1 Resources

In this sense, the term 'resources' refers to people, equipment, and money. As we know, we have a limited supply of all of our resources. But it's important to understand what these constraints on our resources are because they impact the amount of work that we are able to do, the amount of time we have available, and the cost of completing the project. Knowing what resource restraints you have is important when you are planning a budget so that you make a realistic plan.

For many of us, estimating and understanding the use of external resources (contractors, suppliers, government officials, etc.), is easier than estimating and understanding the requirements and cost of using our own internal people or resources for a project.

To demonstrate this, let's look at the costs involved with the use of people as a resource. Time is money since everyone is probably paid for what they are doing at your organization. You also may not have the needed expertise inside your organization to successfully complete a highly technical or specialized project. So your costs for people could include:

- The cost of a 'fill-in' employee for each person while they work on the project
- The cost of lost productivity on other projects for each person working on your project
- The cost of training involved for them to be able to work on the project
- The cost of hiring a technical expert or support staff

There are also a finite number of hours in the day and a limit to the amount of work that you can accomplish in that time. The amount of work that you can achieve is dependent on the number and complexity of the project's objectives as well as its performance criteria. For example, if you have one objective and you've been approved to just get it done to a minimum satisfactory level, chances are that will be a lot less work than if you were told the objective must be completed to a superior level of quality or if you have multiple objectives that need to be completed.

There is usually going to be a tradeoff between your resources, the time you have to use them, and the work output that you can produce. You could also say that the amount of work that is required is dependent on the number of resources that are needed and the time that is needed to complete the objectives. This could be a literal calculation, such as:

Number of resources x Time worked = Work Output

This equation can actually help you think through your resource needs and constraints in several different ways. You know that if you have more people, either the work output will increase or you can keep the work output the same and decrease the amount of time required to complete the project. If we decrease the work output, we can also decrease either the time or the number of people we need, or both.

Since each resource has an associated cost, your simple cost equation for the project would look like this:

Cost of Resources x Work = Total Cost

So to reduce our costs without reducing the work amount (and, we assume, work quality), you would need to reduce the cost of the resources used either by the number of people, the level of people, or the time that they work.

What is the point of this discussion? The point is that whatever decision you make regarding your resources, you will have to make sure that you have accounted for the right combination of resources in your budget.

When it comes to writing the budget for a project, you may particularly face restraints such as:

- Budget cycles
- Budget request processes
- Contingency plans/funds
- Foreseen and unforeseen costs

> If you have well-qualified people on the team, they may be able to work smarter – and faster – than if you have less-qualified people on board.

If you know of an upcoming project, creating a project document and draft budget is vital because it explains clearly what you believe your resource needs are. If it is approved, then you have the commitment that the requested resources will be provided. It also offers management the opportunity to deny the resources you've requested and ask that you 'scale back' the project. By knowing what your constraints are, you can describe the trade-offs it would require in time or quality of outcome to do so. You can then adjust the budget accordingly.

8.4.2 Performance Criteria

As described in the last section, performance criteria affect the resources that you need. The higher the criteria that you are expected to meet, the higher the cost will be to complete the project. When you are developing your project budget, you might want to consider proposing different levels of performance outcomes and their associated potential costs.

Remember, though, that there are indirect costs of reducing performance criteria. If you are rolling out a new product and you decide that you will limit end-to-end testing in order to reduce the cost of the project, you may very well end up with higher costs after the launch because of a system failure or mass customer complaints. So, educating the decision makers in the organization about the possible indirect costs of adjusting your performance criteria is important when creating a project budget.

8.4.3 Time

Looking back at our earlier discussion and formulas, we know that time also affects the cost of our project, and time constraints may also impact the availability of necessary resources. There is one point to make about time that we haven't made yet. It is that the quality of the resource, or people, that you have for your project may affect your time needs as well. If you have two well-qualified people on your team, they may be able to do the same work as four un-qualified people. So consider being willing to pay a higher price for support if it will save time in the long run. On the other hand, if you aren't concerned about the amount of time it takes to get the project done, you could hire cheaper, unqualified help. Of course, this poses a risk to the quality outcome as well.

8.4.4 Assumptions

As you write your project budget, you will also need to identify your assumptions. These are the ideas and concepts that you have taken for granted when you have been developing the budget. Making a wrong assumption can lead to an inaccurate budget. For example, if the Widget 2000 is your main product, your assumptions might include that the organization intends to maintain the product line throughout the life of the budget. To determine some of your assumptions, you might need to ask yourself questions such as:

- What have I assumed will change?
- What have I assumed will stay the same?
- What agreement from other parties have I assumed that I have?
- What suppliers, vendors, consultants, or other outside support have I assumed will be available and affordable?
- What time have I assumed would be available from the staff that I need?
- What exceptions to existing processes, rules, or procedures have I assumed would be made for this project or the process of implementing it?

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