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**BUDGETING FOR UNCERTAINTY**

At this time of year, budgeting becomes an increasing priority and planning for the uncertainty that Brexit negotiations will bring adds further complications. Given the recent legal ruling and ongoing negotiations, we hope that this newsletter with our support at Broadoak, will assist you planning for uncertainty so that you are positioned to move more quickly and are better able to react to any unexpected changes in the business environment than your competitors.

At the time of writing, the High Court has required Parliament to pass legislation before Article 50 can be triggered. While much has already been written on Brexit we will briefly outline what this may mean for the coming year. Presently, the decision is likely to be appealed to the Supreme Court and the decision upheld. MP's will subsequently vote on the issue.

While a majority of MPs backed the Remain Campaign, it is unlikely that they will wish to set aside the result referendum (advisory or not). Europhile MPs may see this as an opportunity to water down our exit (the so-called "soft-Brexit" option) and the triggering of Article 50 may be delayed beyond March 2017. It may even trigger an early election.

Certainly, nobody really knows what Brexit "looks like". We do however know that the coming 2-3 years will see business and industry uncertainty and volatile financial markets. The best we can do is to plan for and accommodate this uncertainty.

Through a flexible budget and sensitivity analysis we can show you how to position your business for the medium term. Information truly is power. The better we understand how our business performs financially, the more likely we can identify the correct decisions and ensure we identify any mistakes.

**Why prepare budgets?**

Budgets are a natural product of distilling a strategic plan into a 12-month time frame. Having established the strategy, management must develop control systems to ensure that the plan is implemented effectively.

These systems should address all aspects of the organisation, including financial, operational, risk, R&D and HR issues. A budget quantifies the costs and benefits of such a plan and also provides a mechanism against which to monitor the progress of the plan.

We fully acknowledge that the budgeting process is a time-consuming exercise. We would however encourage businesses to invest time and serious thought in this process as a budget ultimately performs far more than one function.

We will see later that budgets provide a mechanism for making decisions, monitoring performance, conducting analysis, maintaining financial control, communicating strategy, ensuring coordination and motivating both managers and staff.

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**Budgeting techniques**

Businesses will take different approaches in completing their budget, depending on historical performance, business model, industry type and life cycle stage, strategy and economic trends. There are however two common types of budgets: master budgets and flexible budgets.

A **master budget** is fixed at a predetermined level of activity. A **flexible budget** 'flexes' with the level of activity. For example, if the number of units manufactured or if your cost base changes significantly due to exogenous factors that are not planned for in the original budget, the original budget can be restated for the new level of activity or costs. Traditionally only the variable and semi-variable costs would be restated and the fixed costs would remain unchanged. We will touch on this later in monitoring and variance analysis.

We would also note that **operating budgets** generally refer to the P&L and **financial budgets** include balance sheet budgets, cash flow budgets and capex budgets. **Non-financial budgets** include operational items such as units of output, activity levels or inputs measured. Naturally all interrelate.

Zero-based budgets (ZBB)

When preparing a ZBB we must **justify every revenue and expense line** item as though it was the first time that the budget had been prepared. Consequently, this requires us to consider the cost/benefit of all business activities and encourages us to reduce controllable expenses such as wages and salaries and marketing expenses. Clearly this requires a significant resource commitment and we would not recommend it be done annually. It is best suited for start-ups, new investments or businesses that have experienced a significant change in ownership or business model.

Incremental

Last period's **financial figures are taken as a base and a percentage is applied** to allow for inflation or other expected changes. The primary advantage is that it is very quick to prepare but it has little informative value, it may lock in and even reinforce adverse behaviour and some changes may not be fully contemplated.

Top-down

Financial targets are determined centrally at a **senior level** in line with strategy. While this is often very quick to prepare there may be limited 'buy in' from less senior members of staff who may have a better understanding of the true business conditions.

Bottom-up

The opposite of the above, where line managers prepare the budgets based upon the knowledge of the day-to-day performance and this information is in turn aggregated as we “move up” the organisation. The main advantage is that because it is prepared by those who are responsible for achieving it, there is greater accountability.

The main disadvantage is that subsequent amendments by senior management may not be accepted by staff or that staff may build in budgetary slack so that the budget can be met without significant effort.

Top-down and bottom-up

Naturally a hybrid of the above two. Budgets are proposed by line managers while strategic direction is set by senior management and a compromise is achieved for an agreed output based on agreed resource needs. It does however require extensive planning.

Kaizen budgeting

Kaizen budgeting is more of a culture and less of a budget. It focuses on continuous improvement and small incremental improvements that can be found by employees during the budget period. Many companies that have cost reduction as a strategic focus use kaizen budgeting to continuously reduce costs and staff are incentivised accordingly.

The underlying philosophy is that employees who actually do the job, whether in manufacturing, sales or distribution, have the best information and knowledge of how the job can be done better. These companies create a culture in which employee suggestions are valued, recognised and rewarded.

Some organisations may use a combination of approaches when completing a budget, e.g. an incremental approach for small expenses (stationery) where usage is not expected to change dramatically, a zero-based approach for large discretionary items like travel and entertainment. Large manufacturers may also introduce elements of Kaizen budgeting.

**Flexible budgeting and Sensitivity analysis**

As mentioned above, a **flexible budget** recognises different cost behaviour patterns and is designed to change as the volume of activity changes.

**Sensitivity analysis** involves changing an independent input variable (unit sales) to see how sensitive the dependent variable (net income or free cash flow) is to the input variable. By varying sales, we can determine how sensitive net income is to changes in revenues, assuming that all other factors are held constant. The key to sensitivity analysis is to only change one variable at a time. We may also choose to vary product margins or key cost items. **Scenario analysis** is similar but involves changing more than one input variable simultaneously.

We may also choose to change the relationship between revenue and expense items. If sales are up by 10% and power expenses are up by 15% is this because we are manufacturing more? Have our rates increased or are we producing less efficiently at higher levels of output?

If GBP drops by a further 5% against the USD or EUR, what effect will that have on our revenue or expenses? How will that impact our customer or suppliers, will we have to reduce prices, will increased costs be passed on to us, are we able to pass-through these increases? Should we consider incorporating pass-throughs into our contracts?

Sensitivity analysis is only as good as the model used to represent what is being evaluated. The model must be complete, it must reflect relationships accurately, and it must use accurate estimates. If the model is complete and reflects capacity, cost, and revenue relationships accurately, we need only ensure we use accurate input data.

In terms of forecasting, other quantitative techniques can also be used such as linear regression, multiple regression, time series analysis and exponential smoothing where an established sales pattern for forecasting sales exists. These methods enable a business owner to extrapolate past and present sales trends to arrive at an accurate forecast.

**Benefits of budgeting**

There are both qualitative and quantitative advantages to preparing detailed budgets. The more emphasis and time we invest, the greater the benefit is likely to be. We also strongly advocate preparing strategic plans which requires considerable planning every 5-10 years which will save time preparing annual budgets. Some businesses may also choose to consider a hybrid top-down and bottom up review every 5 years and then prepare incremental budgets in the interim.

The 5 main benefits are:

1. Promote **coordination and communication** among units within the company
2. Provide a **framework** for judging performance
3. Provide a **benchmark**
4. As a **leaning tool**
5. **Motivate** managers and other employees

<u>Coordination and Communication</u>

Coordination ensures that all departments work together in order to meet budget goals. **Communication** is making sure those goals are understood by all employees.

**Coordination** also forces executives to think of relationships among individual departments. Naturally, marketing must coordinate with sales, product development with sales, sales with production and production with finance to ensure funding is in place to meet both production and sales targets. Cleary communication is vital.

<u>Framework for Judging Performance</u>

While budgets enable us to **measure actual performance against predicted performance**, there are limitations of using past performance as a basis for judging actual results. Primarily, past results may often incorporate past mistakes and substandard performance. Another limitation is that future conditions may differ significantly to the past.

The final and most important consideration is how management is used to assess performance. If employees feel targets are unrealistic or fail to take into account forces outside their control, budgets may also be de-motivating. This is likely if a large portion of revenue is unpredictable, non-recurring or outside a staff member's control. We shall illustrate by way of example.

If we consider 2 sales managers at the end of June (six months into the year). Managers A and B have met 90% and 10% of their annual target, respectively. Manager A knows that they will likely meet their target and Manager B that they will likely miss it. Both have little incentive for the remaining 6 months and are likely to push sales into the following year. A wise manager may introduce a stretch target for Manager A and after addressing remedial action with Manager B, identify a monthly run rate that is realistic for the balance of the year.

<u>Provide a benchmark</u>

It is imperative to remember that a company's budget **should not be the only benchmark** to evaluate performance. One may also consider performance relative to peers as well as improvement over prior years. If our revenues have grown at 10% but the industry has grown at 15% we have lost market share, so such gains, irrespective of whether they achieve budget should not be celebrated.

If we evaluate performance relative only to a budget and incentivise staff accordingly, **budgetary slack** may also occur. In order to avoid this, negotiations should occur among managers at each level to understand what is possible and what is not.

<u>As a learning tool</u>

One of the most valuable benefits of budgeting is that it helps managers learn. When actual performance falls short of budgeted or planned performance, it should prompt senior managers to ask questions about what happened and why, and how performance can be improved in the future. This should not only focus on errors but identify the successes that were achieved and the rationale used at the time, in order that the same decision making process can be repeated.

Motivating Managers and Employees[1]

Research shows that challenging but achievable budgets do indeed improve employee performance. Employees view falling short of budgeted numbers as a failure and are motivated to work more intensely to avoid failure than to achieve success. As employees get closer to a goal, they work harder to achieve it.

This would suggest, that not only is a realistic target fundamental but the process of developing a target engages staff. Creating a little tension may improve performance, but overly ambitious and unachievable budgets serve only to increase anxiety without motivation because employees see little chance of avoiding failure.

**Monitoring your financial performance**

The most common method of assessing performance is **variance analysis**. At the very least, all businesses should internally report monthly and YTD financials for the current year against prior year and budget. Many businesses also prepare comparatives for the past 12 months on a rolling basis.

Why is variance analysis so important? It identifies why our financial performance differs to our prior expectations and is used hand in hand with flexible budgets. If the level of output is the driver for a number of costs (e.g. direct materials, direct labour and variable overheads), each item produced or service provided will have a standard cost. The below example illustrates that more flour (albeit cheaper & possibly lower yielding) has been used than budgeted for leading to an **unfavourable efficiency variance** but **a favourable price variance**.

**Flour used in production**

| | Amount used (kg) | Price/kg | Cost (£) |
|---|---|---|---|
| Budget | 10,000 | 5.75 | 57,500 |
| Actual | 11,500 | 4.85 | 55,775 |
| | | | **1,725** |

In conclusion, by analysing last year's performance we can identify which constituent parts of the business performed poorly due to external factors (e.g. exchange rate volatility) and then exclude those drivers from the rest of the business.

While uncertainty in the coming years may be unavoidable, a comprehensive understanding of how it will impact our business will give us a competitive advantage over our competitors.

[1] R. Larnick, G. Wu, and C. Heath, "Raising the Bar on Goals," Graduate School of Business Publication, University of Chicago, 1999