10 Steps to Successful *Budgeting*

Lianabel Oliver and Eduardo Nin

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Preface

"Most people don't plan to fail; they fail to plan."
—John L. Beckley, American author and businessman

We started writing this book before Hurricanes Irma and María ravaged Puerto Rico, the island where we live and work. Before Hurricane Irma, we were preoccupied with the normal ups and downs of daily living. Although Irma caused major damage in some parts of the island, we were confident that power could be restored quickly and normalcy would return soon. Then, on September 20, God opened the floodgates of Hell. Still reeling from Irma, we were unprepared for the force and devastation that María brought to the island. There was a Puerto Rico "before María," and now there is a Puerto Rico "after María." Our lives have changed forever.

Despite the hurricanes, we continued writing this book, albeit under suboptimal conditions—no water, no power, no Internet access, no cable TV. Because this book is about planning and budgeting, we can tell you that no amount of planning can prepare you for what statisticians called a "black swan event," a term coined by Nassim Nicholas Taleb, a finance professor, writer, and former Wall Street trader. *Black swans* are high impact events, which are unexpected and unpredictable. Hurricane María was our black swan.

Although you cannot plan for a black swan event, you can certainly prepare for one, particularly in the case of natural disasters. There is a lot of value to planning, which is the underlying foundation of a budget, both on a personal and professional level. Planning can help you assess the external factors that may represent opportuni-

ties or threats to your business. It can also help you examine your strengths and weaknesses as an organization, as well as your readiness to manage the external environment in pursuit of your vision and long-term goals.

We hope this book will deepen your understanding of the planning and budgeting process and provide a valuable guide to assist you during your next budget cycle.

Introduction

If you are like most managers, you probably feel a heightened sense of anxiety at the start of the budgeting season. It represents one more item on an already full plate, and one more distraction from your real job of running the business. You dread the endless meetings, the difficult negotiations and, worst of all, the budget cuts that often put you on edge with key members of your team.

We concede that budgeting can be a stressful exercise. Top management must balance the needs of all stakeholders and their expectations of financial performance. There are never enough resources. The budget becomes a negotiation process between what you believe you can accomplish with the available resources and what your manager wants done. It can be frustrating and demoralizing for both you and your staff.

But there is good news! The budgeting process can be managed. The key to successful budgeting involves planning, organization, documentation, preparation, and follow-up.

A sound budget is based on a well-thought-out plan, with long-term and short-term objectives and accountability for results. The development of this plan requires time, effort, and commitment from all key players, but particularly from the senior management team. If they are not committed, your planning process will be flawed and so will your budget. The budget process also requires regular progress reviews and, most important, actions that will be determined based on those reviews to help you reach the desired end state.

To be successful, you should understand where your company is going and its short-term objectives for the next fiscal year.

Identify any environmental factors you need to address and analyze how well you are positioned to manage them. You'll also need to understand how your budget affects the organization's financial and operational performance. The budget is the financial quantification of the resources you need to run the business; therefore, any budgeting decisions will affect your organization, and ultimately be reflected in the financial results.

Each planning and budgeting cycle represents an opportunity for change. It is a chance to revisit the old and embrace the new. The budget is not something to fear on your "to do" list, but a time to reexamine who you are, what you do, and how you can use your resources more effectively. How you approach this process will determine your success in achieving your short-term and long-term objectives.

About This Book

This book will walk you through the fundamentals of planning and budgeting in 10 simple steps. Their essence can be summarized in one key learning objective: **Plan first, budget later.** These key steps will make the budgeting process less of a burden and more of an opportunity for you to understand and drive your business success. This book will help you understand how to work through and manage a budget and realize that preparing a budget is part of a larger, more complex process involving teamwork and management commitment to ensure a successful outcome.

Starting with a macro perspective, this book provides an overview of the planning and budgeting process and how it is typically structured within an organization. We discuss the functions of the process and the major elements of a strategic plan. We then move from this macro perspective to what interests you as a manager—how to prepare a sound budget and defend it to the next level of management. Our combined experience of more than 30 years in planning and budgeting will help you navigate this process successfully.

Chapter-by-Chapter Overview

Step 1: Know the purpose of planning and budgeting.

As you read through this step, think about your own company's planning and budgeting process. Does it fulfill all these functions? Where does it fall short? How can you help fix it?

Step 2: Know the planning and budgeting cycle.

This step defines and describes the elements of a strategic plan and discusses the importance of identifying roles and responsibilities, establishing accountability, and understanding critical interdependencies.

Step 3: Know the elements of an operating budget.

As a manager, you will be actively involved in the preparation of the operating budget for your areas of responsibility. You should understand where you fit into the big picture of your organization, and how your information gets rolled into the financial statements.

Step 4: Communicate budget requirements and obtain commitment.

This step is key and should be completed before you start developing your short-term plans, and definitely before you start calculating numbers. Remember, budgeting is not an exercise for the Lone Ranger!

Step 5: Analyze the operating environment for your areas of responsibility.

This analysis will provide your team with a shared understanding of the opportunities and threats in the external environment over which you may have limited or no control, and the strengths and weaknesses of your areas of responsibility to address them.

Step 6: Develop short-term objectives, strategies, and tactical plans.

Here we emphasize the use of SMART objectives (specific, measurable, attainable, realistic, and time-bound) and the identification of key metrics to measure your progress throughout the year.

Step 7: Prepare your departmental spending budget.

This step is probably what motivated you to buy this book. We explain how to quantify the resources you need in financial terms to implement your work plan and achieve your short-term objectives. We describe how to analyze the key activities of your department, determine staffing requirements, analyze your cost structure, and calculate major spending categories. We have also included a tool, "How to Estimate Your Departmental Spending," which summarizes common line items and suggests a possible estimation base to calculate the budgeted amount for each.

Step 8: Obtain approval for your budget.

This step is probably the most stressful part of the process. We explain the different levels of review and how to come to terms with the inevitable budget cuts. We also discuss how to manage the review process, as well as some dos and don'ts that will make the process less painful.

Step 9: Communicate plans and priority projects.

Similar to step 4, this step is about the communication process once your budget has been approved. We have participated in many budgeting exercises where budget cuts and performance expectations are not communicated back to the key players who have to execute the plans. This breakdown in communication can result in missed objectives, budget overruns, very unhappy managers, and frustrated employees.

Step 10: Review performance against plan and act!

This step completes the planning cycle and brings it full circle—you plan, budget, execute, and review. We show you how to analyze

budget variances and monitor progress against your objectives. Most importantly, we emphasize the need to *act*! We have seen many managers analyze their budget variances month after month and do nothing. This action (yes, doing nothing is an action) defeats the purpose of analyzing your actual versus budgeted spending levels. Variance analysis should spur you to take the necessary actions to keep your organization financially and operationally on track. We end this step explaining the nature of the financial forecast, its role in the planning and budget cycle, and its importance.

This book will provide you with a valuable reference tool to plan, prepare, and defend a budget that is strategically aligned to your organization. We urge you to highlight key passages, earmark pages for quick review, and share it with new managers who have never participated in the budgeting process. Remember: A budget is the financial quantification of the resources you need to support the business objectives for the next fiscal year. Make sure you keep your eye on the ball as you go through this process. Happy budgeting!

Step 1

Know the Purpose of Planning and Budgeting

Overview

- Recognize the difference between planning and budgeting.
- Know the functions of a plan.
- Use the planning process to drive results.

You've just received the dreaded email from your finance department announcing the start of the budgeting process. You think of the countless meetings, the endless negotiations with your boss, budget cuts—stress, stress, and more stress. How can you survive with your sanity intact? There must be a way to make the process more manageable.

Budgeting will always be a painful process. It takes time and effort to develop plans for the upcoming year and estimate the resources required. It is particularly difficult when you are preparing your budget months in advance of the start of the fiscal year.

Your budget is part of a larger process called planning. It cannot be done in a vacuum and be must connected to the mission, vision, goals, and objectives of the organization. Planning is not something that is done once a year or once a quarter. Good planning requires constant revision and high involvement from operational managers. Those plans are translated into budgets and forecasts, which show the expected financial results of the proposed strategies.

The first step to successful budgeting is knowing the purpose of planning and budgeting in your organization. Let's start by explaining the difference between planning and budgeting, and how they are interrelated.

Recognize the Difference Between Planning and Budgeting

Planning involves identifying the goals and objectives for a specific time horizon and the specific strategies and action plans to achieve them. It should be based on a thorough analysis of the internal and external operating environment. These plans are eventually translated into budgets and forecasts, which are used to track and monitor performance.

The budget is a financial document that quantifies, in monetary terms, the action plans of the company over a short period of time, typically a year. Some companies have started to stretch the budget horizon beyond a year to 24–36 months. This requirement forces managers to think beyond a year as many strategies and action plans cannot be fully implemented in a 12-month period.

During the budgeting process, managers should strive to maximize the use of organizational resources aligned with the strategic direction. The budget is a means to an end, not an end in itself. Often, you can get so involved in crunching the numbers that you forget the strategies and action plans that are driving the numbers. You cannot cut a budget without affecting your plans for the year, unless you have sandbagged the numbers. *Sandbagging* is a commonly used term in the budgeting process whereby a manager overestimates the amount of spending required, which then allows for flexibility when budget cuts are requested. We do not recommend this approach and will explain why in later chapters.

Now that you understand the difference between planning and budgeting, let us review the reasons why companies plan.

Know the Functions of a Plan

Planning and budgeting require a large investment of time and resources. Why do companies invest such a significant, and often seemingly disproportionate, amount of resources in this effort? A well-thought-out plan serves several important functions within the organization.

Resource Allocation

The planning process forces you to think beyond the day to day and determine what resources are required to achieve your objectives. Resources include materials, people, equipment, facilities, and funding. These resources are quantified during the budgeting process. The budgeting process is when the rubber meets the road. It is the time to ask and answer some hard questions and determine if you must scale down your plans to meet management expectations.

POINTER

Questions to assess the adequacy of your resources:

- What resources do you need?
- What resources do you have?
- Are your resources properly aligned and allocated?
- Is there redundancy in your areas of responsibility or with another department or business unit?
- Can you do more with less?

Resource allocation is a key function of the planning process and allows the organization to evaluate if they have the right resources in place to support the business. This assessment may entail taking some resources away from you to give them to another priority area.

Spending Control

The budget establishes a control mechanism to ensure that you spend the money assigned according to the plan. Through the budgeting process, management authorizes an amount of money to achieve specific objectives. It is not a pot of money to spend as you please.

In well-managed organizations, you will be required to explain why you spent more or less than the planned amounts. You may also be required to incorporate any changes to the business environment in a financial forecast or identify specific actions you have taken to meet or beat the budget.

Communication and Coordination

The planning and budgeting process provides a unique opportunity to coordinate the efforts of various parts of the organization and minimize redundancy of functions and resources. In some organizations, the right hand does not know what the left hand is doing. During the planning process, you should share your plans with your peers to ensure that they are aligned and move the organization in the desired direction. Ideally, all members of the management team should be able to comment and provide feedback on the plans of other areas.

This communication is even more critical for support areas, such as facilities, human resources, finance, and information systems. We have seen projects grind to a halt because a key support area was not included in the planning and did not have the necessary budget.

POINTER

If you involve your team in planning and budget preparation, make sure you communicate the end result once the process is finished–for example, tell them what got approved, what didn't, and what was postponed, as well as the reasons for these decisions.

Finally, it is important to involve key members of your team in the planning and budgeting process. Your team may have critical information that you are unaware of and can assist you with the number crunching and data collection. This involvement will ensure their buy-in and provide you with some assurance that you have not overcommitted the organization.

Feedback

The planning process generally results in an annual budget you can use to monitor and evaluate your performance. The budget also provides a systematic mechanism to update the plan based on changing business conditions.

The budget is presented and reported in monetary terms. It measures *efficiency*, which is how the money was used by major spending category. However, it does not measure *effectiveness*—if the money spent achieved the stated objectives. Therefore, the budget

should be tied to key performance measures that will allow you to evaluate if the resources consumed in your area are achieving the desired results. Some examples of performance measures may include units sold, units produced, labor hours per unit, overtime hours, customer complaints, percentage of on-time shipments, backorders, cost per unit, and cost per employee.

You should determine the important performance measures for your areas of responsibility and ensure that these are reported on a monthly or quarterly basis. Your revenue or spending levels may be right on target in monetary terms, but your performance measures may indicate that you are not achieving your objectives or that a problem is brewing on the horizon.

Simulations

The planning process allows you to perform simulations or "what-ifs" and understand the financial implications of your plans without playing them out in real life. You should build a financial model for your area based on key assumptions and change these assumptions to understand how they affect your budgeted amounts.

Simulations allow you to determine whether your plans are realistic or if you require more resources than the organization can afford. They will also help you identify areas of opportunity to bring your resources in line with management expectations. A robust financial model can help you foresee difficult situations and develop contingency plans *before* a crisis occurs.

External Demands

Do you ever wonder where senior management gets the financial information that they report to Wall Street or their bankers? You guessed it—the planning and budgeting process! Outsiders to your organization, such as Wall Street analysts, investors, and banks, require your company to provide information on its future direction. The accuracy of this information has implications for the prestige of the company in the investor community and, if publicly traded, can ultimately affect the stock price.

Budgets and forecasts are used to communicate regularly with external users of financial information. The planning and budgeting process culminates with the preparation of *proforma financial statements* that summarize the results of the company plans in monetary terms. Proforma financial statements are those prepared based on plans and assumptions about the internal and external environment. They usually include a balance sheet, an income statement, and statement of cash flows.

Use the Planning Process to Drive Results

The planning and budget process can be a powerful tool to drive business results if properly structured and managed. Now that you understand the functions of planning and budgeting in your organization, you should use this knowledge to identify or review how you can improve the process, either in your own area or for the organization as a whole. Some actions that you can take are:

- Identify the weak links and areas of opportunity in the process.
- Look for ways to eliminate redundancy and rework in your own area of responsibility or with other areas in the organization.
- Improve communications with your peers and subordinates. Understand their plans for the upcoming year and give them your feedback.
- Ensure you have adequate feedback mechanisms to raise a red alert when you deviate from the plan.
- Develop financial models to prepare for contingencies and budget cuts.

Use the budgeting self-assessment questionnaire in Worksheet 1-1 to help you evaluate your own budgeting process and identify areas for improvement.

The Next Step

The budget should never be a straitjacket that prevents you from doing what is right. The process should motivate you and your people to take the right course of action within the resource limitations of the organization and management expectations. We conclude with words of wisdom from Professors Charles Horngren and George Foster of Stanford University: "Changing conditions call for changes in plans. The budget must receive respect, but it should not prevent a manager from taking prudent action." Next, step 2 addresses the importance of understanding your organization's planning and budgeting cycle.

Worksheet 1-1

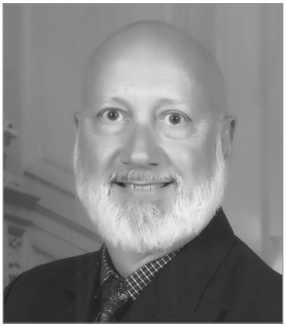
Budgeting Self-Assessment

Use this budgeting self-assessment questionnaire to help evaluate your budgeting process and identify areas of opportunity. If you answer no to any question, identify the actions that you can take to improve in this area.

Task	Yes	No	Actions Required
1. Do I know the organizational priorities and expectations for the budget?			
2. Did I establish my short-term plans and objectives before preparing the budget?			
3. Have I verified that these plans are aligned with management expectations?			
4. Have I discussed these plans with my direct reports and my boss?			
5. Do I know the plans of my peers or other critical areas of the organization that may affect me?			
6. Can I quantify the resources needed with the information I have?			
7. Do I know who I depend on for critical budgeting information?			
8. Do I know who depends on me for critical budget information?			
9. Have I defined the key financial and nonfinancial performance measures for my area?			
10. Is my budget based on a financial model in which I can easily change key assumptions?			
11. Do I have a systematic mechanism to monitor my actual performance against the plan on a monthly basis?			
12. Do I understand how to communicate changes to the budgeted plans and their potential financial impact?			

About the Authors

Lianabel Oliver, MBA, CPA, CMA, is the founder and CEO of OBALearn, an online learning company that empowers professionals with financial concepts to make better business decisions. With more than 23 years of experience in management training and consulting, she is a recognized expert in the fields of strategic planning, budgeting, cost management, and accounting. Over the years, she has designed and facilitated financial training programs for many Fortune 500 companies and professional associations. Lianabel has participated as a speaker in many national and international conferences. She is the author of *Designing Strategic Cost Systems: How to Unleash the Power of Cost Information* (2004) and *The Cost Management Toolbox* (2000). Her most recent publications include "Preparing and Defending Your Training Budget" (*TD at Work*, December 2017) and "Financial Skills That Every Manager Should Have" (*TD* magazine, June 2018). Lianabel holds an MBA from Stanford University and a BA from Yale University. She is a certified public accountant (CPA) in the Commonwealth of Puerto Rico and a certified management accountant (CMA) by the Institute of Management Accountants.



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