

The Advisor – Summer 2015

Budgeting as a Management Tool

Most businesses generate a budget as part of their annual planning routine. Yet a number of them simply generate a budget as a requirement by their lender. Once it's prepared and submitted to the bank, it's never looked at again.

That's a shame, because it's a missed opportunity to drive management behavior and operational results.

So how does a company ensure that the budget is an effective management tool? Some of the key characteristics include:

- 1. Budget future results on a monthly basis.** This allows management to perform variance analyses and make changes to strategy more quickly than if done on a quarterly or annual basis.
- 2. Ensure the budget includes a balance sheet and a cash flow.** Many companies consider a budget to be a forecasted income statement and nothing else. This is a fatal mistake. Without a balance sheet and cash flow, managers cannot determine if the company has sufficient working capital to support any forecasted sales growth. In addition, a cash flow is extremely important for companies that experience seasonality in their business cycle as cash tends to tighten up in periods of low sales. A capital intensive business requires a cash flow to project asset additions and the corresponding financing needed to acquire those assets. A balance sheet is also crucial in assessing covenant compliance with the company's lending facilities.
- 3. Have multiple budget versions.** Management should generate three scenarios of the annual budget: most likely, optimistic and pessimistic. The most likely scenario is the one that is "published" and used to manage the business. There is no need for a re-forecasting exercise if after a few months results start to trend towards one of the other scenarios; management can simply revert to the more appropriate scenario and take the required actions to ensure the new budget's results are met.
- 4. Use the budget to generate compensation plans for sales and operational staff.** Compensation plans for salesmen should be tied to the monthly sales forecasts inherent in the budget. Gross margin and overhead expense targets should be established to generate compensation plans for operational managers as well. There is no doubt that the budget will be monitored very closely by management once their compensation is tied to it.

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In addition to the annual forecast, there are other management tools that can be used in conjunction with a budget to drive results:

- 1. Balanced Scorecard.** This summary (usually one page) report should have five or six key success factors vital to a company's performance that can be monitored on a regular basis. Color coding the scorecard is ideal so that managers can immediately assess where things stand as soon as they read the report. Items that are behind target are coded red; items on target or better are coded green. Some of the more popular items that we've seen scored on this report include: sales targets, timeliness of ERP systems implementations, new customer acquisitions, margin enhancement initiatives and research and development projects.
- 2. Daily Flash Reporting.** This report should be generated automatically from a company's ERP or management system and is usually sales focused. Items such as month and year to date sales are reported and compared to prior month and year to date results. Backlog or orders on hand are also useful metrics that should be tracked daily.
- 3. Headcount Report.** This is an extremely useful report, especially for companies with multiple locations or divisions. It tracks the number of employees and consultants (i.e. full time equivalents) on a monthly basis by department, location etc. Comparisons to prior months and years can be made to determine if the headcount relative to departmental performance is appropriate. Other metrics such as sales per full-time equivalent can be useful as well.

Aries Advisory Group has extensive experience in formulating budgets as effective management tools for companies. We work with clients to assess the key success factors that drive the performance of their businesses. We then ensure that the budgets and management reports are designed to monitor these factors closely in order to effect any corrective action on a timely basis. Please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.

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