6 Making budgets work

About this chapter

This chapter considers the role of the budgeting process as a key factor in implementing the strategy of an organisation. Budgeting has an essential role to play in converting the objectives of the strategic plan into financial statements' projections to provide a standard for performance for the short to medium term future (usually up to 18 months ahead). If used correctly, the budgeting process ensures that organisational resources, such as capital and labour, are allocated efficiently and effectively, and provides a vehicle for departmental coordination and communication. This chapter considers the role of budgeting and forecasting with reference to the following:

- Budgetary planning process
- Using a forecast update
- Behavioural issues
- Budgetary control
- Improving the effectiveness of the budgeting and forecasting process.

Learning objectives

On completion of this chapter you should be able to:

- Prepare a SWOT analysis to support the planning process
- Prepare a budgeted trading account, cash flow and balance sheet
- Update a forecast
- Understand how to analyse the actual performance with variances
- Understand the behavioural aspects of budgeting.

Introduction

Technology has enabled budgeting and forecasting to become embedded at an operational level in the hospitality and tourism industries. Departmental managers can expect to work to weekly and monthly budgets for revenues and costs, and be required to reforecast revenues and costs on a regular basis. Achievement against budget is usually a critical element in departmental performance. However, successful budgetary planning and control systems require certain conditions to be in place. Best practice in budgetary planning and control depends on:

- **Frequency and timeliness** of management reports, and the hospitality and tourism industries this means daily business reports, weekly trading reports and monthly reporting packs.
- **Flexibility** in preparing budgets by introducing rolling budgets rather than relying solely on an annual fixed budget.
- **Accountability and ownership** to ensure that departmental managers feel motivated to raise actual performance to meet budget expectations.
- **Transparency and access** to financial data and measures ensures that managers can lead teams to achieve maximum performance.
- **Accuracy** in reporting ensures that managers are working with comparable figures and have confidence in the information for decision making.

Budgeting and the strategic planning process

The budget provides a short-term plan for the organisation and is normally prepared in advance of the financial year with a detailed plan for the year ahead. This plan should be drawn from the long-term plans of the organisation providing a scheme for the implementation of the organisational goals and objectives. The budget should be more than just an extension of last year's actual results with incremental increases for revenues and costs. However, for many organisations the budgeting process is reduced to this basic exercise, which ensures that each year more and more slack and inefficiency is built into the budgeted values. Instead, the budget setting exercise should reflect the current and planned activities of the business allowing for a distinction between two types of activities:

- **Maintenance activities,** these are a continuation of existing activities.
- **Development activities,** which can be considered to be new opportunities in terms of products or markets or both.

A maintenance budget reflects an organisation pursuing well-established activities, whereas a development budget should reflect changes in strategic direction, such as investment to expand or changes in product or market base. A budget for a business planning to launch a new product or concept will require a capital budget for capital expenditure and in the operational budgets, high levels of marketing costs. A business in the mature stage or entering the decline stage of the product life cycle will need to budget for substantially reduced marketing and investment costs and will focus on the cutting of critical costs.

The purpose of budgets

The successful implementation of the budgeting process should achieve a number of aims. These include enabling the organisation to:

- **Quantify future plans:** the budgeting process compels operational managers to look ahead and set short-term targets. This enables shortfalls in sales and resources to be identified and provides the opportunity for measures to be implemented to overcome these difficulties.

- **Set performance objectives and targets:** the budgeting process provides the opportunity to set targets to raise operational performance by increasing management motivation levels.
- **Co-ordinate departmental activities:** the preparation of the sales budget for each trading department forces the different departments to co-ordinate with each other. This is particularly true in a hotel where the restaurant sales budget is dependent on the forecasted room occupancy levels.
- **Communicate plans and objectives:** the budgeting process provides a formal opportunity for higher level managers at divisional regional levels to set targets based on the long-term objectives of the organisation.
- **Control business performance:** the process provides a standard based on expected revenues and costs to which actual performance can be compared. Variances between actual and planned performance can then be identified and inefficiencies targeted and eliminated.

The whole budgeting process can be time-consuming and costly in terms of management resources. Critics of the process argue that the cost and time involved is not justifiable because the end result is based on many unknown factors and the actual performance will almost certainly be different. This needs to be considered in the light of the overriding benefit of the process, which is that it forces managers to consider all relevant factors likely to affect their business and plan for the effective use of resources, and this requires both an internal and an external analysis.

Finally, it can be argued that the budgeting process encourages managers to spend up to budget. Certainly, it is true that this can occur towards the year end when responsibility centre managers note that they have not utilised the full value of their expenses budget and are tempted to spend more than is required. This can be minimized through effective communication and participation in the budgeting process. Many businesses in the hospitality, tourism and leisure industries use participative budgeting techniques, engaging their management teams and supervisors. This contrasts with a top-down approach where budgets are set at a senior level and imposed on the teams who will be working to the targets set.

Determination of goals and objectives

The budget is the translation of the organisational business and financial goals into monetary values. The nature of organisational objectives has already been discussed in detail in Chapter 1 and there it was concluded that goals may range from profit or revenue maximization through to just pure survival tactics. The short-term planning in the organisation should aim to achieve long-term objectives but invariably conflict can arise. For example, maximising return on capital employed in the short term may mean that the long-term future of the business is compromised. Emphasising the maximisation of this ratio means that there is a temptation to artificially increase profits by cutting expenditure in areas such as maintenance, training and marketing, whilst plans for further investment in assets are curbed. Therefore, it is far better to use more than one criteria for setting targets and assessing performance.