

Summer 2016

Budgets

Budgets are part of the strategic planning process similar to forecasts, which were the subject of our last newsletter. But budgets are much different than forecasts. It is important to distinguish between forecasts and budgets because they are prepared differently and have a different business purpose.

Budgets are detail-oriented and focus on day-to-day management and control. Budgets usually cover a time frame of a year or less. They are used to set goals, control costs and evaluate a company's and management team's progress. They are often developed with a heavy reliance on historical data, but well-made budgets are consistent with the company's strategic plans. So planned changes in operations should be built into the budget.

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Preparing and Using Budgets

Similar to forecasts, there are different ways to develop budgets. Top-down budgets are defined by top management and communicated down to operating managers. Top-down budgeting is most often used in centralized management structures. Bottom-up budgets are defined by operating managers and are reconciled and approved by top management. Bottom-up budgeting is most often used in de-centralized management structures.

An important part of a good budgeting process is to regularly review and update the budget. A good practice is to review budget-to-actual figures every month, if not more often. Budgets are an important tool for managers to use because they provide a guide for managing operations and allow management to identify and focus on unusual revenue and expense trends. Without a budget management may not be able to respond quickly enough to head-off a problem. Once the money is spent it is gone, so the budget gives managers a way to react quickly to an unfavorable trend.

Budget Problems

As useful as budgets can be, the budgeting process is coming under greater pressure in recent years. Many business leaders (including Jack Welch) have said that the budgeting process in many companies is actually harmful. Some of the problems with the traditional budgeting process are:

1. **"Use it or lose it" mentality** – If an expense is budgeted, operating managers will often spend the budgeted amount without regard to its usefulness. The thought process is, if they don't spend it the funds will be cut next year and their department will shrink.

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- 2. Deferring necessary expenditures** – If an expense is not budgeted, but is necessary, operating managers will often not incur the expense. A greater focus is placed on meeting the budget than on taking advantage of valid business opportunities.
- 3. Sand-bagging** – Operating managers will often pad their budgeted expenses to make it easier to come in under budget. When you see an upper management team applying a “lawnmower” approach to expense reduction (as an example, reduce expenses 10% across the board) the underlying cause is often sand-bagging by operating managers.
- 4. Lack of innovation** – As noted previously, more emphasis is often placed on making budget than on pursuing valid business opportunities. When making budget is emphasized, innovation often suffers.

- 5. Incentives are ineffective** – If an operating manager misses budget, the penalties can be severe; and if they make budget the operating manager often gets only a mild compliment. If incentives are not properly structured, operating managers could place greater emphasis on the budget and internal politics than on pursuing valid business opportunities and making the company even more valuable.

If your company has any of these problems, don't worry – you're not alone. Many companies struggle with them. As long as you have a budgeting process in place you can fix it. While there are a number of possible fixes, there is no silver bullet so some trial and error is necessary. The important thing is to be aware of the potential problems and be prepared to act to correct them. Feel free to call me if you think you have a problem in your budgeting process and we can discuss possible solutions.

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Please contact Ronald DiMattia at Corporate Value Partners at (216) 741-1330 or ron@corporatevaluepartners.com with any questions or if you need help with a valuation or corporate finance matter.

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