Chapter 4 – Budgeting

What is budgeting?

Budgeting, by definition, is creating a systematic plan for the expenditure of a fixed resource, such as money, during a given time. Your activity budget is "an itemized summary of estimated or intended expenditures for a given period, along with proposals for financing them" (adapted from dictionary.com).

But don't confuse the words "forecast" and "budget." A forecast is a *prediction* of the future (an educated guess), whereas a budget is a *planned outcome* of the future.

At some point in your career, you will most likely be responsible for both an APF and a NAF budget. Your service will have specific guidelines for format on each. For the purposes of this chapter, we will primarily focus on the NAF budget, as it is more complex. There are three kinds of NAF budgets that an MWR/Services manager may be required to prepare: (1) operating budget, (2) project budget, and (3) capital expenditures budget

Operating Budget

Basically, you will look at a previous year's results and project any changes for the coming year. This is not extremely difficult but does require that you work from an accurate historical basis and also consider all factors which may influence changes in the future. Accurate budgeting is incredibly important. The evaluation of your MWR/Services activity (and the performance of its manager) will be based at least in part on operating results as compared to budget.

Project Budget and Pro Forma Operating Statements

A project budget is the estimated financial plan for a project for which funding is required. It may look like an operating budget, but it is based almost entirely on forecasted projections rather than past operations. For example, what if you were to open a new Child Development Center on your installation? What would it cost to get it from idea to operation? And what would it cost to operate? Would it be a revenue user, or a revenue generator? Or, what about creating a huge community event for the Fourth of July? What revenues might you expect? What costs would you expect to incur? What is the anticipated difference between those two figures? This projection is done via a "pro forma" operating statement. Pro Forma is simply a term used in financial analysis to indicate projected figures. As a manager, you will be called upon to provide information to support the pro forma operating statement. This is accomplished through Financial Assumptions. These assumptions are developed via the three-step process below.

There are three major steps in developing a pro forma operating statement: (1) forecasting demand and prices, (2) estimating variable expenses, and (3) estimating fixed expenses.

Step 1 -Forecasting demand and prices

Forecasting demand is the most difficult of the three steps, but it is vital to make the finished product of any value. If forecasted sales are dramatically off target, so are the conclusions drawn from the pro forma statements. You can use both historical data and market research to forecast the demand. Both require as much accurate information as possible, along with skilled analysis of the projected results.

Step 2 -Estimating variable expenses

Variable expenses are either estimated as a percentage of forecasted sales, or incrementally. For example, marketing can be budgeted as a percentage of sales, and it *can* be a constant percentage. Labor, on the other hand, does not vary directly with sales. There is a certain labor cost to "open the doors" regardless of sales, then it changes based on increments of projected sales.

Step 3 -Estimating fixed expenses

Historical information is probably the most useful starting point for estimating fixed expenses. But it may be more of an art than a science. Start with what you already know, factor in the changes that you project, and determine your "best guess" as to the expected fixed expenses. Look at the operating statements of similar projects to ensure you do not overlook a factor.

We cannot over emphasize the importance of providing accurate forecasts in developing pro forma statements to support specific project budgets.

Capital Expenditure Budget

Capital Expenditures is referred as amount of money needed to spend on capital items (furnishings, fixtures, and equipment) or fixed assets such as land, buildings, etc. that are projected to generate income in the future. Capital expenditures to be budgeted include replacement, acquisition, or construction. Therefore a Capital Expenditure Budget is prepared for individual capital expenditure projects. This will be discussed more in Chapter 5.

The Budget Cycle

Budgeting is a continuous cycle. You create a budget for a new project, or for current operations, and then analyze actual data from operations and compare it with the budget … after which you create a new budget, based on the actual information.

The budget cycle for your MWR/Services activity will be set by your Service headquarters, and it is necessary to scrupulously follow the guidelines and deadlines because your budget flows into a larger budget requirement. Keep in mind that the budgeting cycle actually overlaps. You have to submit next year's budget before this year's financial results are completed.

Variance Analysis

When comparing your actual operating results to your budget, there will probably be variances (The budgeted figures will not be the same as the actual figures.). This can be caused by calculation errors, changes in plan, external factors out of your control, or poor budgeting.

Variance analysis is the comparison of actual figures to those in your budget. For example, you might have budgeted for a 30% labor cost, and had an actual cost of 35%. The variance is 5% over, which helps explain a likely negative variance in the net profit!

Actual Figure – Budgeted Figure = Variance

If you use computerized spreadsheets (such as Microsoft Excel), all you have to do is fill in the numbers and look at the results. The use of the spreadsheets reduces (but does not eliminate) human error and speeds up calculations, as well as allowing you to quickly see the impact of changing various parameters.

If the variance is negative, meaning sales are less than projected or expenses are more than projected, it may be too late to correct the situation for that accounting period. But it's never too late to initiate corrective action for future periods.

Even if the variance is favorable, it is important to know why the results did not match the forecasts. Perhaps it is an inventory error, which will then cause the next financial results to be skewed in the opposite direction. Or perhaps the marketplace has changed, and you can take advantage of the change to improve your results even more.

One of the most common mistakes is under budgeting in order to provide a large positive variance. You may think it makes you look good when in fact the more accurate the budget the better it is for the entire fund. Under budgeting can be a hindrance to those tasked with prioritizing projects or capital purchases based on cash flow projections that rely on the operating budget.

Variance analysis can be frustrating, especially if you're not hitting your financial targets. However, it is a wonderful tool to identify how to get back on track.

Three Common Budgeting Mistakes

1. Overstating projections: It is tempting—perhaps even natural—to assume that sales will be excellent, expenses will be managed, and profits will flow. Optimistic projections may even help you secure financing. But *realistic* projections will better serve your activity in the long run.

2. Confusing cash flow with profitability: If there is money in the bank account, managers may think that everything is fine…without looking at seasonal trends and future expenses. Or the financial statements may show net profits, yet there is not enough money to meet payroll. We'll look at the different kinds of financial statements in another chapter. But when budgeting for a going concern, both revenue and cash flow budgeting is required.

3. Forgetting an important ingredient: Your budget may show a net profit, in accordance with your Service's requirements, and then actual results remind you that the occupation costs are higher than they used to be. Perhaps you didn't allow for an expense previously paid for by appropriated funds, or maybe you're being battered by inflation. Getting the expenses as close as possible is critical when forecasting.

Summary of Chapter 4

Budgeting is the process of creating a systematic financial plan. Three kinds of budgets prepared by MWR/Services managers are (1) operating budget, (2) project budget, and (3) capital expenditures budget. The Budget Cycle is a continuous and overlapping process, and variance analysis is critical to adjust future budgets and identify errors, changes in the operating environment, or changes in the marketplace. Three common budgeting mistakes are: (1) overstating projections, (2) confusing cash flow with profitability, and (3) forgetting an important ingredient. *Budgeting is a fantastic tool for managers!* Without the discipline of the budgeting process, and the insights provided by the results, few mangers would be able to maximize their success in serving their customers in a cost-effective manner.

A concise, well-planned budget is a valuable management tool, and should be carefully constructed each cycle using accurate historical data and thoughtful analysis of future impacts to both expenses and revenue. The time spent preparing your budget can help you serve your customers more effectively in the future. Budgeting can actually help *eliminate* the pressure of time as it helps identify potential problem areas before they occur and allows the manager more control. Budgets are required by each service…so why not use them to their full potential!