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CHAPTER 4

THE UNIT MANAGER'S WORK OF BUDGETING

Now no unit exists in a vacuum, self-contained in its work. All units need inputs and support *from* other organizational elements, and all units supply outputs *to* other organizational elements that those functions need as inputs and support for their work. In a factory, the shipping function is the only one that has outputs direct to the customer; all other factory units hand their outputs to other internal organizations. Thus, another important result of budgeting is each unit's definition of its needs from, and outputs to, other organizational elements within the company. This is required to ensure that the whole company is going in the same direction to carry out the desired strategy.

Thus, what is required from unit managers in budgeting is to generate good predictions for next year of:

- Expected costs
- Achievable outputs
- Requested supplemental information
- Needs from, and outputs to, other organizational elements within the company

ACHIEVABLE OUTPUTS

One of the results of budgeting is *achievable outputs*, which may or may not be the same as *required outputs*. A factory assembly unit may be told that 3,000 widgets are needed next year. If, after diligent analysis, the unit manager believes that only 2,500 units can be produced, 2,500 is the number that should go into the budget. Higher management wants the best prediction possible; if the forecast is not satisfactory, resources can be added or redirected or plans changed. No one's interests are served if the requested number of assemblies is just parroted back in the budget with no hope of accomplishment.

OK, so it is budget time. The budget forms have arrived on your desk, and you have been told to submit the unit's budget in two weeks. Or, if you are not the unit manager, you have been asked to budget your part of the unit's work. One hopes you have been given extensive guidance, but perhaps not (see the box at the end of this chapter). What do you do?

The simple illustration of completing the payroll budget form in Chapter 3 only scratches the surface. A function like payroll probably does not change much year to year, and the illustration still left some questions up in the air about how to generate certain budget numbers. We have to answer those questions, particularly for units whose specific work content changes every year.

To decide what has to be done, you first have to understand what is required from budgeting.

THE REQUIRED RESULTS OF BUDGETING

As noted in Chapter 1, all unit managers are required to predict their units' costs for next year. Some managers have to forecast the outputs that can be achieved: revenue, shipments, assemblies, transactions, service repair calls, and the like. Many managers also have to supply supplemental forecasts of various kinds.

New budgeters tend to think that there is some magic way to generate good budgets, but the only magic is in the principles and techniques, hard work, knowledge, and intelligence.

PLANNING THE UNIT'S WORK

To supply these required budgeting outputs or results, unit managers and their key people must first answer a whole set of questions:

- What are we expected to accomplish?
- How are we going to accomplish it? (That is, what processes and activities are going to be involved in getting our work done?)
- What inputs and support do we need, and can we get, from other organizations within and outside the company?
- What kinds of effort, purchases, services, and costs are involved in getting our work done?
- How do I know everything you are telling me won't change as the year moves along?

What have we just said? We have said that *unit managers first have to plan their unit's work for next year*. This is the first component of the unit manager's work of budgeting.

We will discuss what a plan is at greater length in Chapter 7. For now, we can say that a plan tells how you are going to get from point A to point B. In business plans in general, point A is the set of resources, skills, processes, and working environment that your unit now possesses, and point B is the set of things that need to be accomplished. For the budget, point B is the set of things to be accomplished next year.

Planning the work requires that the unit's work must first be understood, so a prerequisite is *defining the unit's work*. This takes effort, but it is effort that managers should expend anyway, just to do their jobs. Defining the work is more complex than it may seem, so Chapter 6 is devoted to the right way to define the unit's work.

Once the work is defined and understood, the outputs expected of the unit over the next year, with the required

schedule, must be identified. Similarly, the kinds and amounts of inputs and support that will be available, and when, must be determined. Then, how you are going to do the work must be decided. This is all discussed in Chapter 7.

The joker in this work planning is the inherent uncertainty of the future, reflected in the last question in the series at the beginning of this section. However, as explained in Chapter 1 in the box on page 7, the uncertainty makes the planning more important, not less. The uncertainty cannot be avoided—future uncertainty is not resolved until time passes—future uncertainty is not resolved until time passes makes the future the present—but it can be handled and its effects minimized. Future uncertainty looms so large in budgeting that handling it is covered next, in Chapter 5.

GENERATING THE NUMBERS

All the planning work goes for naught if you predict the output and cost numbers poorly. For example, you can be perfect in thinking through every single step involved in painting a house; however, if your estimates of the amount of paint needed and the time required are way off, your cost estimate will be worthless.

Generating the budget numbers properly is the second component of the unit manager's work of budgeting. In reality, of course, the work of generating these numbers is not divorced from the planning work of budgeting. Indeed, predicting the numbers is the result, and the natural last step, of the planning. However, it is appropriate to discuss number generation separately, because there is a right way and a number of wrong ways to choose the numbers that actually go into the budget. In the house-painting example, the right way to estimate labor would be to plan all the steps—cleaning, spackling, walls, trim, etc.—and estimate each from experience. A wrong way could be to base labor hours on total square feet without regard for the particular preparation required.

Chapter 8 discusses how to generate the budget numbers in general. Because cost estimating is so large a part of budgeting, it is treated separately in Chapter 9.

MAKING ESTIMATES

Are you basically uncomfortable making estimates? Some people are. Do you resist putting numbers down until you have complete information? Some people do. However, companies and their managers need to plan for the future, and need to predict the consequences of those plans so they can choose the best plans for next year. Making uncertain estimates and predictions is central to management and budgeting work, so budgeters must get comfortable with the idea of dealing with those uncertainties. If you find it hard to be comfortable, remember that part of your problem is just your state of mind. Given that businesses need predictions, seeking certainty is an illusion in any case. Only when an event has happened and you are recording history will you find certainty. And, if business prediction were simple, they could replace you with a high school kid, right?

The other part of getting comfortable with predictions is to make them in the way that results in the most probable prediction possible. The first step is defining and planning the work, covered in Chapters 6 and 7. The rest is using the best principles and techniques to put numerical values on the results of the planning, the subject of Chapters 8 and 9.

GETTING THE RIGHT BUDGET APPROVED

Obviously, developing good budgets is of no benefit if managers cannot get them approved. While expressed as numbers of dollars for different kinds of costs and outputs, budget approval really means the acceptance and authorization of your plans for next year, including:

- Expected and committed results
- Resources required to achieve the results
- Needed capital investments
- Action programs to generate outputs, improve performance, and reduce costs
- Support and inputs required from other organizational elements

Getting the right budget approved is not a trivial task. It is a selling job—the “customers” being the bosses—involving a set of objective and subjective factors like any other selling job. It requires the same amount of energy and focus that must be applied to the rest of the work of budgeting. Therefore, it is the third major component of the unit manager's work of budgeting, and Chapter 11 is devoted to it.

CONCLUSION

This then is the unit manager's work of budgeting:

- Planning the unit's work for next year
- Generating the cost and other numbers that go into the budget submission
- Selling the budget so that the right budget gets approved

Our concern is that unit managers get approval of budgets that give them the resources they need to accomplish what

Every manager's particular budgeting problems are unique. However, the right principles, techniques and practices can be applied beneficially in every company.

is expected of them. Thus we need not be concerned with budgeting theories: nor do we need to become experts in accounting, investment analysis, or the like. What we need is more insight into this work of budgeting:

- Chapter 5 discusses how to handle the ever present uncertainty in budgeting.
- Chapter 6 shows how to define the unit's work, which is the prerequisite for planning for next year.
- Chapter 7 discusses how to plan next year's work.
- Chapter 8 describes how to generate the numbers that go into your budget.
- Chapter 9 treats cost estimating, by far the most common budget numbers that have to be generated.
- Chapter 10 shows you how to put all this work together in an efficient process.
- Chapter 11 describes the all-important final step: selling your budget and getting the right budget approved.

PREBUDGETING ACTIVITY

At some enlightened companies, higher management specifies "what," in terms of goals, strategies, priorities, and problems for concentrated attention. They rely on the rest of the managers and their key people to decide "how" to carry out their wishes, and "how much" it will cost and use scarce resources. Therefore, before budgeting starts, higher management actively directs the identification of critical factors for success, problems, and desired improvements. It also communicates preliminary budget targets that will constitute satisfactory performance.

If you work for an enlightened company, be thankful, because your budgeting work is a lot easier. All managers at such companies begin their bud-

gets with good knowledge of what the company wants to do next year, what is generally expected of them, and what top management's priorities are.

Unfortunately, many companies are closer to the opposite extreme. Unit managers learn that the budgeting process has begun when forms arrive at their desk. The forms are accompanied by a letter from accounting giving a few ground rules (such as "assume salary increases average 5 percent") and stating that the manager's budget numbers are due back to accounting in a week or two. There is also a pep talk letter from the controller noting the importance of minimizing costs next year. Needless to say, managers in these companies have to be creative to figure out what higher management wants. The planning element of their budgeting work is particularly important: Unit managers need a coherent, logical framework to defend their budget submissions. Such a framework lets them understand cause and effect, the parts of their budget submission that will be changed by requirements different from what they assumed. Thus the changes that probably will flow from the budget reviews will be easier to accomplish.

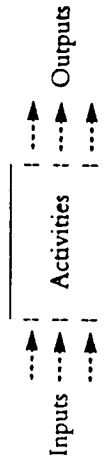
CHAPTER 6

DEFINING THE UNIT'S WORK

Definition of the unit's work should be done before budgeting begins, because the ever present time pressure will make it difficult to accomplish during budgeting.

Unit managers and their key people must understand their unit's work, not only for budgeting, but to be able to manage that work. The work definition is usually more complex than it first appears, and requires some effort.

The proper way to define the unit's work is in terms of its outputs, inputs, and activities. Visualize your unit's work in terms of the following flowchart:



Outputs are the physical or informational things that the unit produces—product designs, assembled units, reports, paychecks, and so on. *Inputs* are the "raw material," instructions, and the like, that are supplied to the unit to do its work. *Activities* are what the unit *does* to transform inputs into outputs.

Most of a unit's outputs go to other units, and most of its inputs are outputs from other units. Further, different choices of activities change the inputs required. Thus outputs, inputs, and activities are the nuts and bolts of how different units and functions work together to conduct the business, and the place where performance improvements and cost reductions are made. For a payroll unit, automation of time records (that is, different inputs) would eliminate or

change review, data entry, and error correction activities. Similarly, the activity change of switching to an external payroll service would change most of the inputs that the payroll unit requires.

Each unit's work definition is different, of course, so you have to determine your own. However, this chapter will show you how.

ACTIVITIES

Let's start with activities. People tend to talk in terms of functions ("I am in sales"), but discussion in activity terms ("I make cold calls and sales presentations on products A, B, and C throughout Ohio") gives a better basis for managing the work, improving performance, predicting costs, and reducing costs. Thus, a focus on activities is the best way to define the work.

An activity is the way a business employs its resources (labor, materials, time, information, and technology) to produce particular outputs. For example, material flow in a factory can be discussed in terms of the functions involved: possibly material management, quality control, and accounting. However, those words don't tell you what you have to *do*. Much more information for managing and budgeting is contained in descriptions of the activities involved: Receive material, inspect material, move material, store material, pay for material, and supply material to assembly.

The activities a unit performs are determined by:

- Its required outputs
- Management decisions regarding equipment, people, processes, and procedures
- Inputs

Activities usually fall into a sort of hierarchy. In defining them, choose the level that is useful in managing and that involves significant costs. "Prepare reports" can be viewed

as including the subsidiary activities of "creating reports" and "typing reports." These would be significant for a word processing unit, but not for an engineering function. The engineering unit may even consider "preparing reports" not worth identifying. That is, the engineering unit manager may decide to focus on activities like "design products," "modify products," and "maintain configuration control," and consider preparation of reports only an incidental part of each.

Further, the principle of diminishing returns applies to definition of activities. The important thing is to define high-cost and highly variable activities, and to relate them to outputs. An "other" category is useful and permissible for support and incidental activities that do not vary much with output. Every organization should also have something like "administration" to cover activities like training, appraisals, and employee communication.

OUTPUTS

There are many types of business organizations with many kinds of outputs. The *primary outputs* usually follow directly from the organization's function: assembled products from an assembly unit, orders from a sales unit, paychecks from a payroll unit, customers served from a restaurant operation, copies from a reproduction center, and products shipped from a division.

The next step must be the *specifications* that complete the description of the primary outputs. For the assembly unit, this includes specifications of the products assembled and the required quality level. For the sales unit, it includes the products sold and the geographical area or market in which they are sold. The paychecks from the payroll unit must be on time and correct in gross amounts, deductions, and net amounts. And so on.

Beyond these primary outputs, every organization has *information outputs*. The assembly unit must provide time records

Revenue is not primarily an organizational output. In the sense of the work to be done, revenue is a by-product of outputs such as products shipped and services delivered.

by project for its personnel, records of output achieved, and reports of usage and storage of toxic materials. The sales unit must report its sales calls and submit travel expense reports. The payroll unit must prepare and submit payroll tax returns. Plans, budgets, material requests, and such are required from most units.

Most organizations also have what we can call *service outputs*. They must satisfy inquiries and complaints, provide expertise to sister organizations in solution of problems, and the like. Sales, factory, and service people all have expert advice to give on design and features of new products. A reproduction center's primary output—copies—is a "service," but its service output is advice on what is possible, best, and most cost-effective in reproducing documents.

Ordinarily, the primary outputs are the main determinants of activities and costs, but not always. In some cases, information outputs—compliance with federal environmental, safety, and tax regulations—can add considerable effort and cost. Important outputs are not necessarily only the obvious ones, which is why deliberate analysis and observation are needed.

INPUTS

There are essentially three kinds of organizational inputs.

1. There are the things on which the organization operates, which we will call the *material*. These are the things that are traditionally considered inputs to any activity in the narrow definition of the term. For an assembly unit it is the material to be assembled, for an engineering function a new product requirement or a problem to be solved, for payroll it is the time records.
2. There are things from other functions that help an organization conduct its activities. These are the *tools*, assistance or support. Examples are computer programs, candidates for employment from human resources, artwork, and physical tools and equipment.

3. There are things that prescribe how an organization will do its work, the *instructions*. Examples are drawings, data entry procedures, bills of material, and policies and procedures.

Consider a sales unit. Its material inputs are the products and services to be sold and identification of current customers. Tool inputs can be advertising and sales promotion, proposals and quotations prepared by engineering, management visits, financing arrangements, and contract forms. Instructions include price lists and allowable terms and conditions, antitrust policies, order-entry procedures, and expense account rules for entertaining customers.

The material inputs can be physical things, such as component parts for assembly, faulty equipment for maintenance service, cash for a banking transaction, and the goods to be sold in a retail store. It can also be information, evidenced by paper or bits stored in a computer. Information is probably the more common input to business organizations: all the activity records that are accounting's inputs, product descriptions for sales, product requirements for engineering, material requests for purchasing, signed applications for insurance rating and pricing, and so forth. In the same way, tools can be physical things or information. Instructions are always information.

OUTPUT DICTATORS

OK, we have outputs, inputs, and activities, but we are not finished yet! To complete the definition of the unit's work, managers must understand what dictates their outputs and what causes or drives their costs (covered in the next section).

Once an organization's outputs are defined, the next task is to determine what dictates those outputs, so that you will know where to look for the numbers that define next year's budget.

Some organizations have outputs dictated directly by orders, contracts, or revenue. Examples are an engineering organiza-

tion totally devoted to customer development contracts, a service function devoted to customer maintenance contracts, and most sales organizations.

More typical are organization outputs that are dictated by *derivatives of revenue*. Factories generally have a planning function that schedules all factory operations. Assembly, test, and machine shop organizations have their outputs defined by these schedules, rather than directly by revenue. For organizations whose transactions generate revenue—cashing checks, selling a security, or switching telephone calls—the transaction itself is the output that determines the work, rather than the revenue involved.

The next logical category is *outside requirements*, independent of revenue. Legal and regulatory requirements, markets, and competition all dictate company outputs, for example, annual and quarterly reports, compliance with environmental regulations, proposal information that satisfies government procurement regulations, and special services provided to match competitors.

Some outputs are dictated by *structural factors*. These dictators are a result of the physical, procedural, and organizational way in which the company does business. The way a company is organized fundamentally establishes the responsibilities and outputs of all its units. The fact of locations in a number of states and countries dictates a particular set of shipping, tax return, and communication outputs.

Finally, there are units whose outputs are dictated by *requests for service*. Their outputs are determined simply by the demands of their "customers," and they might be called "level of effort" functions. Reproduction, word processing, art departments, and parts of facilities are examples of such functions.

In practice, one organization may have outputs of all the above types. A purchasing unit in a manufacturing department can have outputs dictated by pass-through revenue, production schedules, and inventory policy; an outside requirement to report on the proportion of orders placed with

The most important use of the knowledge of cost drivers is not in budgeting but in improving organizational performance. The cost drivers show where to look for the biggest improvement pay-offs.

small or minority businesses; and a service requirement to fulfill random headquarters purchasing needs.

COST DRIVERS

The things that cause or drive the unit's costs must be understood for the unit's work to be planned and budgeted intelligently. Knowledge of cost drivers is also important in evaluating changes during the budgeting process, and also changes in plans during the course of the budget year. That knowledge allows managers to understand quickly whether such changes will have major or minor effects, whether they require quick reaction or can be taken in stride.

Required outputs and output dictators are obvious cost drivers. Usually, the more products assembled or engineering changes to be made and processed, the higher will be the costs. Also, output complexity and diversity increases costs. Changing output requirements to specify higher-performance products will increase purchased material and manufacturing costs. The characteristics of required outputs that drive cost are generally identical with the output dictators discussed in the previous section: revenue, derivatives of revenue, outside requirements, structural factors, and requests for service.

Procedures and processes, the way the work is done, is the second general class of cost drivers. Another way of saying this is that costs are driven by the choice of activities and inputs. In general, the two biggest factors that affect procedure and process cost drivers are the degree of automation and the number of things an organization does versus what it buys.

The general *price level* is also a determinant of costs, and this includes the price levels for everything an organization buys: purchased material prices, wage levels, rent levels, and so on. This type of cost driver is usually beyond the manager's control, and price changes can invalidate a budget quickly. (Price levels of important items are always candidates for budget assumptions.)

SUMMARY AND PROCESS: DEFINING THE WORK

For an existing unit, the process of capturing the way things are currently done is neither more nor less than thorough observation and recording. When an existing unit is presented with requirements for new outputs, the process of defining the work is one of design rather than observation: Given a new output, what work (activities) will we do to accomplish it, and what inputs do we need? A new unit must define the work from scratch, and that is the manager's first task.

For all cases, use the following step-by-step process:

1. *Start with the required outputs.*
 - Primary outputs.
 - Their specifications.
 - Information outputs.
 - Service outputs.

Use the general categories of output dictators as a checklist to ensure that nothing has been missed.

2. *Determine what dictates each required output.*
 - Revenue.
 - Derivatives of revenue.
 - Outside requirements.
 - Structural factors.
 - Requests for service.

This both helps you understand the output requirements better and tells you where to look for the amounts and values of outputs that have to be reflected in your budget.

3. *Decide the way you want to do the work to produce the outputs.*

- Define all the tasks involved in producing the outputs.
 - Group your conclusions into significant and manageable activities.
4. *Identify the inputs needed for each of the defined activities.*
 - What are the materials (physical or informational) that must be operated on or transformed to achieve this output?
 - What tools, assistance, and support are needed to do this?
 - What instructions are needed?
 5. *Iterate among outputs, inputs, and activities to determine the most practical and cost-effective way to produce the outputs.* Inputs needed for preferred activities may be unavailable or too expensive, requiring activities to be changed. Ask the following questions:
 - Is there a better way to do the work?
 - Are there other activities and inputs that will give better performance and/or lower costs in producing the outputs?
 - Since your unit's outputs are another unit's inputs, are there different outputs that will improve overall company performance or reduce company costs?

6. *Determine the causes or drivers of unit costs.*

Concentrate on those things that most strongly determine the organization's cost level. If monthly reports are an incidental cost, don't worry about what drives their costs. In identifying cost drivers, progress from the definition of activities to the nature of the costs to the drivers of those costs. That is, rather than starting with some general categories of cost drivers, look for what drives the individual cost elements: labor, purchased material, rent, utilities, and so forth.

ILLUSTRATION: A PAYROLL UNIT

Most units have more outputs, inputs, and activities than are recognized intuitively, and all are important for a full understanding of the work. Let's use a payroll unit as an example, because all types of businesses have this function. Most people think the work of a payroll unit is conceptually simpler than some functions, so you may be surprised at how many elements its work definition contains (and a particular payroll unit may have more than this example):

Outputs: timely paychecks for every employee, in the right amount, with the correct deductions withheld; all the correct records needed for business, tax, and employee purposes; submission of all required payroll tax returns; and satisfaction of inquiries and complaints.

Inputs: pay and deduction instructions, charging instructions, time records, computer programs, data entry procedures, and general company policies and procedures.

Activities: specifying paycheck and pay stub information (we assume paychecks are actually prepared by data processing, a different unit), reviewing and entering time records, reviewing payroll data prepared by the computer, entering changes in salaries and deductions, correcting errors, making adjustments, delivering paychecks, preparing tax returns, handling inquiries, and administration.

Principal output dictators: number of employees, frequency of paychecks, complexity of pay methods and benefits (for example, overtime, piece work, commissions, numbers and choices of employee medical insurance plans), and the number of states and countries in which served employees work (which determines the number of different income tax withholding schemes that must be accommodated).

Principal cost drivers: all the output dictators, the number of errors and adjustments that must be made, degree of automation of time records, and whether an outside payroll processing service is used.