



Budgeting: Why and How

*Act before there is a problem.
Bring order before there is disorder.*
—Lao Tzu

Budgeting is more than just a job we have to get done to satisfy the financial department. Planning and budgeting can help us lead our team to success. Sometimes, when we write a plan, we catch errors. It's a lot better to catch errors in a plan than to have problems later on in the office or on the shop floor because you didn't catch the errors. In fact, it's been shown that good planning will typically reduce the costs of a project by about a factor of 10.

In this chapter, you will learn how to create a simple expense budget. There's a lot here, but don't worry. Every idea in this chapter will be explained further on in the book in more detail. Our goal for this chapter is to create a simple success together: your first budget. Let's go!

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Plan A written document describing what you are going to do to achieve a goal. It usually includes the steps involved and a timeline for completion.

Budget A plan that includes the money you will spend and when you will spend it. In addition to expenses, a budget can also include income.

Team The people who work with or under you to achieve a goal you all share. It doesn't matter if your organization calls them a team, a department, or anything else. What matters is that you will support and guide these people, all of you will work together, and all of you will deliver the results the organization wants.

Why Make a Budget? Who Reads Budgets?

There are several good reasons to create a budget and to make it a good one. The reasons are tied to the people who will read and use the budget. Each reader will look at the budget in a different way and do something different with it. If you know your readers, you can make a budget that will impress everyone—and, more important, show how your group is contributing to the organization and therefore approve the funds you need to proceed. If you know how the budget will be used, you will know how to write it in an easy-to-use way. More important, it will help you succeed and show that you are a good manager and that your team is doing a good job. So, let's take a look at your audiences and what they will do with your budget.

You and Your Team

You and your team are your first, and most important, audience for your work plans and your budget. When you read the budget, you want it to make sense. This means that you understand it, of course, but it means more than that. The budget should be believable and workable and it should work the way your team works and be appropriate to your situation.

Your Boss


Your boss is your second audience. Of course, you want the budget to be correct, clear, and complete for him or her. If your

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boss checks your work closely, you don't want any errors to show up. If your boss doesn't check it closely, you certainly don't want the budget to go further upstairs with mistakes in it. Your boss will also check the totals of the budget against available funds. In some companies and in many government agencies, the boss will also check the budget against rules and limitations. Some organizations require that top managers approve the line-item budget.

Your boss will also seek or approve funds for the budget. In a company, you may do work for another department, and then bill that department for the work you do. Or the cost may be billed to a client, but your boss will need to make sure that you are planning to spend the right amount of money for that client. Some of the money may come from restricted funds, such as a training budget or government grants. Then you can

A Budget That Works



Nicolai was planning the budget for supplies for a small manufacturing shop. The parts he needed to buy were cheaper by the caseload than by the box. But Nicolai's shop didn't have much warehouse space, so he chose to buy a few boxes at a time, instead of a whole caseload. He spent more on the parts, but he was working within the space he had. The extra money he spent on the parts was worth it, because it saved the cost of renting a larger space to store the parts.



Line-item budget A budget where the name of each line is set, as is the amount of money you can spend on each item. If you must work with a line-item budget, and it specifies \$1,000 for training materials and \$500 for office supplies, you can't spend \$1,100 on training materials and \$400 on office supplies. The authority to move money from one line to another must be granted at a higher level.

Block budget The opposite of a line-item budget. You are given a block of money. You present the details of your plan in line items. But, later on, if you want to spend more on training and less on office supplies, you are free to do so. As long as you don't overspend the block of money before the end of the year, the money is under your control.

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Restricted funds Money that you can use, but only for a specific purpose or with specific limitations or requirements.

use that money only for the purpose specified in the budget. You will have to track this money carefully and you may have to work with other restric-

tions on the funds, such as using particular types of contracts or submitting receipts that prove how the money was spent.

Three other audiences for your budget are the financial department, the accounting department, and, possibly, the human resources department.

The Financial Department

The financial department is responsible for acquiring and planning for the use of all funds within your company. The budget you put together becomes part of the whole corporate budget they create. If your company has an annual report, your plan and budget will appear as a part of the total financial picture. If you deliver a clear budget with no errors, you make their work easier—as well as your own, because you won't have to correct it later on. If your team gets its work done well within your budget, you improve the company's bottom line and help ensure success.

The Accounting Department

The accounting department is responsible for managing and tracking all financial transactions for the company. They will create account codes for each of your line items and assign



Allocated Assigned to be spent for a particular purpose. If your budget is accepted, this means that the money has been allocated for the purposes listed in your budget. Money is usually allocated for use within a particular year.

them in their computer system. Every time money is approved or spent, they will track that event and take from the money allocated in your budget and show it as actually spent.

The Unexpected Raise

Juanita prepared a departmental budget for a year that includes a salary for a current team member of \$36,000 per year, or \$3,000 per month. It looked fine to her. When human resources checked it, they noticed that since each employee gets an annual raise on the anniversary of his or her starting date and this employee started in August, the 5% raise would make the budget off by \$150 per month for the last five months of the year. With the help of human resources, Juanita adjusted the salary to \$3,150 per month for August through December and the annual budget for that line item to \$36,750.



The Human Resources Department

If your budget includes money to pay salaries for you or your team, it will also involve the human resources department, sometimes called personnel. People in human resources work closely with accounting and finance with regard to salary and other employee-related expenses. You should ask them to check your budget in relation to salaries.

Creating an accurate, workable plan and budget allows your team to get the money it needs from finance, keep track of it with accounting and human resources, and succeed. You can succeed only with a good budget. The success of your team or department within your budget looks good for your team, for you, and for your boss. It also helps the bottom line of your organization.

Eight Steps to Creating a Budget

Now that you know your audience, you're ready to begin tackling your first budget. As you work through this section, take your time and make sure that you get a basic understanding of the ideas. If anything is too complicated right now, don't worry. It will show up in more detail in the next 11 chapters.

Choosing Where to Start

There are two basic starting points for a budget. We can look either at what we did before or at what we are planning to do. In

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A Fresh Start

Evan was the new marketing manager for a small company. Up until now, he had always made his budgets starting from what was actually spent in the last two years. But he discovered that this company had done almost no marketing in the past two years because it had three large clients and wasn't looking for new work. Now things have changed. Evan was hired because two of the clients went out of business and the company now needs more marketing. Evan sat down with the company owner and asked him what the marketing goals for the company were for the next year. With the owner's help, he built an accurate marketing plan to meet those goals. Then, starting with the plan instead of the prior year's spending, he made a budget that would allow him to allocate funds more realistically.

the first option, we review a prior year or years and then make changes where we think the future will be different from the past. In the second option, we look at a written plan of what we are going to do and ask, "What will I need to buy? How much money will I have to spend?"

Both approaches are good and you can start with either one. However, if you don't have accurate information about the prior year or you know that this year is going to be very different, then you have to work from a plan, rather than from past results. To make a really good budget, it's best to look at the budget both ways.

Suppose that you have good, actual expense figures from at least one prior year. Does that mean that it's best to start from them? Not necessarily. Sometimes, it's still better to start from your work plan for the new year. This depends a lot on how much production work you do and how much project work you do.

When you're creating a budget for production work, you're probably better off starting from last year's budget. If you'll be working in much the same way, then last year's plan is a good start for this year's plan. However, when you're creating a budget for a project, you're better off starting with your project plan. Because projects are unique, something you've done before is not a good model. Build from your plan so that your budget

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Actual Not Estimated

If you're building your budget from a past year's budget, make sure that you base it on actual spending, not estimates.

Check with accounting to make sure that the figures from last year are accurate and that nothing was left out. Also, think about whether there should be any new categories or line items in this year's budget, then add them, rather than trying to squeeze your new budget into an old plan. You'll probably change the amounts of each line item—that's what estimating is all about—but you'll also want to add or change the names of line items if you have a good reason to do so.



describes what you actually need to buy, hire, or acquire to succeed on the project. Your budget may be broken into different parts and each part can be done either way—based on the past or on the plan. In this chapter we'll discuss the basics of creating a budget from last year's budget. Creating a project plan and budget is covered in Chapter 5.

Production work Any work done in much the same way over and over again. Running an assembly line and processing insurance claims forms are good examples of production work.

Project A temporary endeavor undertaken to create a unique product or service. In a project, you are doing work just once, not repeating it. Building a new assembly line or installing a new computer system to handle insurance claims forms are good examples of projects.



Creating a New Budget from an Old One: Step by Step

In this section, we will create a simple expense budget for this year from a prior year. Later in the book, you will learn to budget income and other elements and to work with several years of information at once. All of the ideas presented briefly here will be explained again with a lot more detail in later chapters.

Step 1: Gathering Information

The first job is to gather accurate information about the past. This is not always easy. Sometimes, records are not kept well. Often, we need to project next year's budget before this year is

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Production and Projects

Robert is the manager of an information technology department, which keeps all of the computers running and also installs new systems. In planning for the coming year, there are three big parts to his budget: support, providing computers for new staff, and installing a new warehouse inventory system.

For the support plan, he builds his budget based on last year's budget, because he expects support for next year to be pretty much like last year. To purchase and install computers for new staff, he talks to HR and learns how many people will be hired each month and which ones will need computers. Then he builds a plan to provide computers before the new employees start work and writes a budget for that project plan. Then he consults with the vendor who's providing the warehouse inventory system and creates a project plan and a budget.

Line items in his budget may be a combination of all three parts. For example, the figure for the cost of new computers would include new computers to replace old ones from support, new computers for new staff, and new computers for the warehouse.

over or before the information on this year's expenses is ready. Sometimes, we can find out what we spent, but we can't get the answer to the magic question: Why?

For now, let's say that we manage to gather information on what we spent last year. Our example is a budget for the



Using a Spreadsheet Program

A spreadsheet program can take a lot of the tedium out of creating a budget. If you know the basics of a spreadsheet program, it will take care of addition, subtraction, and simple percentage increases for you. Later in this book, we'll show you how to have the spreadsheet program check your work for you as well. Many managers take the time to learn advanced spreadsheet functions by taking two or three days of classes or by reading a book and working through the exercises.

There are three popular spreadsheet programs available. Microsoft Excel™ is packaged with Microsoft Office™, so it's probably the most available. Microsoft Works™ contains a spreadsheet tool that is good enough for simple budgets and costs a good deal less. And some companies use Lotus 1-2-3™, which is just as good as Excel for everything you will need to do in a budget.

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photocopy department (“the print shop”) of a medium-sized company (Table 1-1). It’s January 2003 and we need to create an expense budget for the year.

Print Shop Expenses	2002 Actual	2003 Estimated
Equipment leases	\$3,600	
Toner	900	
Plain paper	300	
Special papers	60	
Equipment purchase	600	
Service contracts	1,500	
Equipment repair	350	
Miscellaneous	150	
Sales tax	142	
Total Expenses	\$7,602	

Table 1-1. Print shop expenses (2002)

Step 2: Understanding Each Line

Preparing a good budget is detail work. We need to do more than say, “I guess we’ll spend the same next year.” We need to know why we spent what we did and think about what will change. So we examine each line and, using our own memory, meetings with others, and reviews of receipts and contracts, we understand *why* we spent what we did.

For example, why did we spend \$3,600 on equipment leases? A check of the lease contracts shows that all three machines are on a five-year lease-purchase plan at \$100 per month. Why did we spend \$300 on plain paper? We can check purchase orders, inventories, and copier counters and discover that we made about 5,000 copies per month, which used 10 reams of paper at a cost of about \$25. We ask similar questions about each line item.

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Keeping Budget Notes Throughout the Year

Plan ahead. Whenever you approve a major expense, make a note of why the expense was necessary. It's easiest to keep all these notes in one computer file. You could put them in a word processing document called, for example, "2003 budget notes." Or, if you prefer spreadsheets, you can use the feature that attaches little notes to each cell. Either way, when you sit down to make your next budget, you'll know why you spent money the way you did. In a large organization, you can review the budget monthly and ask people why large expenses occurred and make your notes.

Step 3: Predicting the Future

Unless you have a *working* crystal ball, the best way to predict the future is to picture it, meet with people about what they want and what's happening, and then make an estimated or calculated guess. Your guess will be the best one possible because it's based on good information, your own experience, careful thinking, and accurate calculations.

New managers are often afraid of writing down a lot of guesses and giving them to their boss. That's understandable. But that's all anybody ever does when predicting the future. Reasonable and calculated guesses are the best we can do for budgeting. Even Alan Greenspan, when talking about when the economy will improve, is just making an estimated and calculated guess, based on his team's research and experience. It won't be comfortable at first. But, if you follow the steps carefully and thoughtfully, you'll be surprised how often you'll be right or close, as long as you understand how your office works.

Let's look at some sample line items and see what it's like to predict the future. In examining the lease contracts, you realize that two of the machines have been on lease for only two years and you'll pay another \$1,200 on each of them this next year. But the third machine is now five years old and has a purchase option. For \$350, it's yours. Since it works fine, you decide to buy it. You can now predict lease expenses for 2003: two machines at \$1,200 each for \$2,400. And you add \$350 to

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the equipment expense line so you can purchase the third copier.

Doing this makes you think about service contracts, so you check. The two machines under five years old will have service contracts with renewal options at the same rate, of \$500 each per year. The service company you've been using won't support machines over five years

old. You ask around and a friend tells you that there's a local repair shop that services older machines. You arrange a service contract with them for the old machine at \$600 per year. So, you budget \$1,600 for service contracts in 2003.

Now that we've planned the equipment budget, let's take a look at supplies. We use up supplies to support our rate of production. For a copy shop, the key rate is the number of copies a month and, in our example, almost all of that is plain paper copying. In 2002, the copy shop averaged 5,000 copies per month. Will it be different this year?

The best people to answer that question are your customers. You could go to the manager or assistant manager or secretary of each department and ask them if they are likely to want more copies than last year, or less, or the same. When you add up the numbers, you will have your estimate for production levels, so you can estimate your expenses.

So, checking in with each customer, we discover that we will probably make 72,000 copies this coming year, instead of 60,000, an increase of 20%. How does this information help you estimate your budget?

The number of copies determines the amount of plain paper and toner that you buy. So, we can increase these by 20%.

Accurate Self-Assessment

Expert managers understand the difference between what they know and what they don't know. It's essential to know if there's missing information or if something isn't clear. It is better to say honestly, "We spent \$3,000 on supplies last year, but we lost track of \$600," than to try to hide that fact. We learn best by being honest about the problem or our lack of knowledge and resolving to learn more and to do better next time.

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Smart Managing

Partner with Your Customers

Help your customers think about what they need from you. You might tell them, "Last year, you made 12,000 copies. It looks like 8,000 of them were for two big mailings." Then you can add questions to get them thinking: How many mailings are you doing this year? Is your mailing list growing? Are you doing anything else that will require photocopies?

Helping them think through their needs will not only give you a more accurate budget and make it easier to plan your team's workload, it will also help them appreciate you more. Of course, it's also important to respect your customers' time. If a customer would prefer that you just send a quick e-mail and let her reply, that's fine, too.

Putting in these figures, we now get a projection for 2003 that looks like Table 1-2:

Print Shop Expenses	2002 Actual	2003 Estimated
Equipment leases	\$3,600	\$2,400
Toner	900	1,080
Plain paper	300	360
Special papers	60	
Equipment purchase	600	950
Service contracts	1,500	1,600
Equipment repair	350	
Miscellaneous	150	
Sales tax	142	
Total expenses	\$7,602	\$6,390

Table 1-2. Print shop expenses (part of 2003)

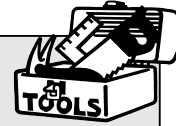
Step 4: Reviewing the Results

Looking at our estimate (Table 1-2), we see that we've got a new figure for every line item that cost over \$500 last year. It's time to ask ourselves some questions before we finish up the budget.

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Budget Review Checklist

- **Does it make sense?** For each item, do the numbers look right? Think about the decision you've made and make sure you're comfortable with it. If not, then get someone's opinion or rethink it yourself.
- **Does it add up?** Even if you use a computerized spreadsheet, you'll want to check your numbers.
- **Are the big items right?** Pay more attention to the line items with higher figures. If any aren't done, finish those first, using the same methods you used in Step 3.



Step 5: Finishing the Budget

Once you complete the larger line items, you need to finish up the smaller ones. In our example, it doesn't matter too much how you do it. Even if every one of the four unfinished items on our budget doubled for 2003, it would only add \$702 to the budget and the total budget would still be smaller than last year.

On your own budget, total up the smaller items. All together, they may be more than half of the budget. In that case, you'll need to spend some time planning them carefully. On the other hand, the small items may add up to a tiny part of your budget, which isn't worth much of your time. This allows you some flexibility to think about how people view your budget and your team. If the "bean counters" like to see level costs, keep the numbers the same. If they expect reasonable growth, then use a growth figure similar to the one used for the big items. If they tend to accept budgets at the beginning of the year, but make it very hard to allocate extra money later in the year, then put in higher numbers to give yourself a little leeway.

In our case, we're going to assume that the small supply items are going to increase along

Bean counter Someone in finance or accounting. The term is sometimes friendly and sometimes derogatory, so be careful how you use it. Most often, the term implies that a person is more interested in accounts and making the numbers look good than in using the money for the things you feel you need to do your work.



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with the large ones, at 20%. But we have no reason to think repair costs will go up. We're nearly finished. The only line left is for sales tax. The sales tax line is a bit different from the other lines, because it is based on a calculation using the figures from other lines. We can add up any line items that require sales tax and multiply the results by the local sales tax percentage. (State laws vary on which items are taxed.) If you're working with a spreadsheet, you can simply enter a formula to perform this calculation for you. In Table 1-3, those line items are in italics. To make it interesting, let's say that last year sales tax was 6%, but this year it's increasing to 8%.

Print Shop Expenses	2002 Actual	2003 Estimated
Equipment leases	\$3,600	\$2,400
<i>Toner</i>	900	1,080
<i>Plain paper</i>	300	360
<i>Special papers</i>	60	72
<i>Equipment purchase</i>	600	950
Service contracts	1,500	1,600
<i>Equipment repair</i>	350	350
<i>Miscellaneous</i>	150	180
Sales tax	142	239
Total expenses	\$7,602	\$7,231

Table 1-3. Print shop expenses (items with sales tax in italic)

Take a look at the sales tax line (in bold). In 2002, sales tax was 6% of the total of the six taxable line items in italics. In 2003, we use the new figures for each line, and we use the new tax rate of 8%. Take a moment to copy these numbers into your own spreadsheet or to use a calculator and check the figures. (If I made a mistake, send me an e-mail!)

Step 6: Adding Budgetary Assumptions

A budget is more than just numbers. Your sources of informa-

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Taxable item A line item that is subject to sales or some other tax. A line item may be subject to sales tax in one situation and not in another. For example, if you buy supplies for internal use in a business, they are taxable. If you buy the same item to produce items for sale, you can make a tax-exempt purchase. And, if you work for a not-for-profit organization, then almost all purchases are tax-exempt. Whether an item is taxable or not also varies from state to state. For example, in the print shop budget, repair services were taxable. In other states, repairs are broken into parts (taxable) and service (not taxable).



tion and reasoning are important as well. With this information, you and others can review the budget, improve it, and easily extend it into the future.

And, if errors appear, it's possible to trace the source of the mistakes. Perhaps your planning was right, but you were given the wrong information to begin with.

Budgetary assumptions

A short document that answers the questions:

- Where did you get your numbers?
- What thinking led you to this estimate?



We put all this information into a one- or two-page document called *budgetary assumptions* (Table 1-4). Keep it short and simple. Also, make sure it is clear so that you can remem-

Print Shop Budgetary Assumptions

General: Year 2002 figures were provided by the accounting department using year-end actual results.

Line item

Equipment leases: Costs lowered because one of three units will be purchased in 1/2003.

Equipment purchase: Increase due to execution of buy option on leased photocopy machine

All supply items: 20% increase based on discussions with customers about expected growth in demand for services.

Sales tax: Calculated as 6% of total taxable items in 2002. Due to rate increase, calculated at 8% of total taxable items in 2003

Table 1-4. The print shop: budgetary assumptions

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ber and explain all your ideas later if you need to.

This document is brief but clear. Not all items are explained, only the most important ones, that is, the ones that changed most or the ones that were based on new rules. Yet this is enough information to make it easy to evaluate and improve your budget throughout the year and to make it even easier to prepare a budget next year.

Step 7: Checking Your Work

You are almost ready to present your budget. But you are probably a bit nervous—and you should be! You don't want to have someone else find your mistakes after you've delivered your budget. So, the best thing is to find those mistakes now and have someone else help you do it.

You need to do more than check your numbers. Capitalization, spelling, punctuation, and grammar are also important. And it never hurts to take a few extra minutes to make a document look good with stylish, professional fonts and formatting. Chapter 6 will guide you through checking your work and Chapter 7 will show you how to make a professional budget presentation.



Learn from the Old-Timers

Most of us may not remember when budgets were done by hand. In those days, mistakes were a lot harder to find. And, strangely enough, there were fewer of them. Having computers makes things so easy that, sometimes, we become lazy or sloppy.

My mother used to project student enrollment for every school in Philadelphia. A co-worker would help her proofread tables by reading every number aloud from the original while she checked the new version. It was a lot of work, but it led to award-winning results.

It's very hard to catch our own errors. We tend to see what we *think* we wrote. We assume that our spreadsheets are working the way we want them to and we miss errors created by bad formulas. To prevent this, work with a partner. Have someone unfamiliar with your work read it aloud while you verify it. If no one on your team is available, help another manager with his or her budget in return for getting help with yours.

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Step 8: Delivering Your Budget


Back at the beginning of this chapter, we discussed the different audiences for your budget. You may well present your budget differently to each audience. (Of course, the numbers should always be the same.)

With your team, focus on how you came up with the figures and how you expect the team to spend money and track expenses through the year. Help them be responsible about tracking money and let them know you support them in having what they need to do their job.

Your manager is likely to want to go over the budget carefully before it goes to accounting and finance. It's good to make the time to sit down with him or her and review your assumptions. Your manager may also want to change some items. For example, if your manager knows that accounting routinely cuts each item by 10%, it may be wise to increase your numbers so you can get what you need.

The financial department may or may not want to see your budgetary assumptions. Some financial departments will not want to see all of your notes but will want certain very specific items. Ask them for their guidelines and samples of the terminology they want you to use. Much of what the financial department prepares is available to stockholders or even the general public; you'll want to follow their lead in presenting information appropriately when it goes outside the company.

Accounting will probably not want to see the budgetary assumptions page. They will want to put the numbers into the computerized accounting system. If they've given you account codes, you'll want to deliver your estimates for the new year with those numbers, to make it easy for them to set up the new year on their system.



Account codes The numbers assigned to expense categories or jobs so that the budget can be tracked throughout the year. We'll discuss them further in Chapter 2.

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Success Review

We've made a really good budget. What makes it good?

- It's written clearly, so that anyone can understand it.
- It is based on good information from our customers and our own experience.
- We started with last year's actual expenses, but we also did some planning for the coming year.
- We researched the most important items and made some good management choices, such as buying the old copier.

In preparing our budget, we've set up our team for a year of success.

There's a lot more to learn. In Chapter 2, we'll look at all the parts of a budget and learn to forecast income. In Chapters 3 and 4, we'll expand on what we did here, so you can create a complete production budget. In Chapter 5, you'll learn how to create a simple project plan and budget. After that, we'll look at presenting your budget, tracking money through the year, and some advanced topics, such as budgeting for small businesses. Even if you thought you weren't that good with numbers, you'll probably find it easy to learn if you go step by step and work out each exercise as you go.

Manager's Checklist for Chapter 1

- Having a good plan and a budget reduces costs by helping you take care of things before they become problems.
- A good budget is made up of accurate information, thoughtful predictions, good guesswork, and careful calculations.
- Any budget contains guesswork. If this makes you nervous, just remember that, if you have good facts and think clearly, your guesses will be as good as anyone else's—probably better.
- You can create a budget from past data or from future plans. If you're doing production work, you're repeating past work,

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so past data is a good place to start. If you're working on a project, then it's better to start from your plan. Either way, check your budget using both approaches.

- ❑ Follow the eight-step plan to creating a budget and you'll create a budget that will help your team succeed and help financing, accounting, and other departments get their work done and work with you.