PERSONNEL NOTEBOOK
For Your Most Important Resource — The Human Resource
PreparedBy:

Human Resource Associates

Human Resource Consultants

The Skills of Top Managers
Part VII

In Parts I through VI of this subject, we reviewed the first 13 of what *Harvard Business Review* (HBR) identifies as the 13 skills that set top managers apart from other managers. Those 13 skills were:

1. **Setting Goals That Inspire Others**
2. **Hiring the Best**
3. **Keeping the Best**
4. **Delegating With Confidence**
5. **Managing Your Time**
6. **Managing Teams**
7. **Appraising and Coaching**
8. **Handling Problem Employees**
9. **Dealing With Crisis**
10. **Developing Your Career**
11. **Becoming a Leader**
12. **Strategizing**
13. **Mastering Financial Tools**

We began number 13, Mastering Financial Tools, with the budgeting process and took a look at various types of budgets.

In this, part VII, we will continue with financial tools by learning how to prepare the master budget.

The Master Budget
The master budget is the heart and soul of the budgeting process. It brings together the two pieces that actually make up the master budget:

I The Operating Budge
II e Financial Budget

Developing the Master Budget
There must be a free flow of information between the operating budget and the financial budget. It's a process that usually begins at the bottom by identifying all the functions of the operation and their costs and income. This information then flows up to become the master budget.

Many (not all) companies use this bottom-up or "participatory budgeting" concept to develop the master budget. Some use a top-down approach which calls for (what does it call for?) There's good and bad to both approaches.

Top--Down Approach
Advantages:
- Budget goals will specifically focus on the company's strategic plan.
- Better coordination of each department's budget requirements.
- Discourages the "padding" of department budgets.
- Generally sets higher goals for managers to stretch.

Disadvantages:

- Upper management may be out of touch with the realities of the operational processes or markets.
- Middle managers may feel left out and less committed to ideas they had no part in developing. They haven't "bought in" to the plan.

Participatory Approach

Advantages

- It brings the people closest to the line activities, supposedly the people with the best information, into the budget planning process.
- Participants not only learn more about all the plans, goals, elements, operations, and the "big picture" of the company, but they also become part of the process. They buy in.

Disadvantages

- The people closest to the operational activities may not understand or see the big picture.
- If performance evaluations are tied to goal achievement, managers will have an incentive to pad their budgets either by underestimating revenues or by overestimating costs.

Making Assumptions

The entire budgeting process relies heavily on each level of management making several estimates or assumptions about what they expect or forecast will happen. In order to makes those estimates or assumptions, they ask the following types of questions:

- What are the expectations for sales and revenues from our products and services?
- Are supplier prices anticipated to rise or fall?
- What will be the cost of the company's health-care plans for the coming year?
- If the availability of labor is in question, will it result in overtime work, cause an increase in wages, or call for subcontracting out some of these functions?
- What will the competition be doing that will affect us?

Assumptions should be sought from the sources best able to know. For example, top management has the clearest view of the strategic goals, and the finance group has records of past financial costs and performance. Look to the human resource group for information on labor market shifts and availability and the sales representatives for sales prospects. The purchasing department should have the latest information about suppliers and price trends.

Tips for Making Assumptions

- Use historical data as a starting point.
- Trust your own experience. Make educated guesses where necessary.
- Take into account your intuition, your gut feelings.
- Seek out and find the information you need: do research, read trade journals, gather industrial statistics, access the resources of your trade association, and use the Internet.
- Discuss your assumptions with experts; talk to your team members, colleagues, and mentors. Seek out industry experts, suppliers, and concerned community leaders. Engage in discussions with your competitors.
- Learn when to take risks and when to be conservative. In volatile markets, your conservative assumptions will usually serve best.
- Test your assumptions. If at all possible, try them out as small experiments before you accept them.

I. The Operating Budget

In a typical for-profit company, the operating budget is made up of budgets from each function of the company's operations, such as research and development, design, production, marketing, distribution, and customer services. The operating budget also

includes the expected income from these functions (as in the profit and loss statement).The operating budget is not just a forecast. It's a target agreed upon by the members of the management team and top management. There is a simple formula that defines the operating budget: Revenues minus (the cost of goods sold + sales, and general and administrative costs) = Operating Income

Five Steps to Prepare Your Operating Budget

Step 1. Calculate your expected revenues
Operations managers must also make assumptions in order to calculate expected revenue growth (or decline). If they use the "incremental-budgeting" approach (explained in issue number VI), they will use last year's budget as the base for next year's projections. However, if they decide to use the "zero-based budgeting" (also explained in issue number VI) they will make their projections starting from the ground up, assuming nothing from the past budget, but instead using forecasted economic data, predicted customer behavior, and other intelligence.

In projecting revenues there are many traps. One of the most prevailing is where managers are evaluated and rewarded on achieving the revenue targets. They will be tempted to set those targets pretty low, thereby making their rewards easier to achieve. This "slack" also makes it more likely that the targets will be exceeded, making managers appear even more effective.

Step 2. Calculate the expected cost of goods sold
Determine the total number of units (or jobs) to be produced. Remember the number of units you forecasted. Identify all the costs of production, including labor and material.

Step 3. Calculate the expected operating income
Consider all the non-production costs such as research, product or service design, marketing, distribution, customer services, and administration.

Step 4. Calculate the expected operating income
So, you have now identified the expected sales and the expected costs. The difference between them is your expected operating income. Top management can now compare this to their strategic plan and the master budget.

Step 5. Develop alternative scenarios
Now we can play some "what if" games. Brainstorming about what would happen if one of our assumptions didn't occur the way we expected? What would be the effect if we increase our advertising? What if we lost some key employees?

II. The Financial Budget

The financial budget is made up of the:

- Capital budget
- Cash budget
- Budgeted balance sheet
- Budgeted cash flows

Three Steps to Prepare Your Financial Budget
Once you know your expected revenue and your expected costs, you can plan for the capital you will need to support those operating budgets. There are three other budgets you must develop.

Step 1. Cash Budget
Include estimated cash from operations as well as other sources, including accounts payable, borrowing, or equity. The cash budget helps to predict and plan for the amount and the timing of cash flow and outflow.

Step 2. Operating Asset Investment Budget

A plan to assure that the needed capital will be available when needed for assets such as inventory and accounts receivable.

Step 3. Capital Investment Budget
A plan that budgets for proposed investments in long-term productive assets such as property, plant, and equipment expenditures.

The cash budgets are particularly useful tools since they indicate shortages or surpluses of cash in each period of the year. No business can afford a shortfall of cash as the company would find itself unable to pay bills when due.

With this information, senior management can now create the master budget. Using the company's established strategic plan as the foundation, the master budget begins by asking three important questions:

1. Do the functions spelled out in the operating budget being considered support the larger and long-term strategic goals of the company?
2. Does the company have the required resources, (e.g. the cash) it needs to fund these activities *throughout the immediate budget period*?
3. Will the organization create enough value to attract adequate resources, profits, loans, investors, etc., to achieve the long-term goals?

As a top manager, whether using a participatory or a top-down process to develop your budget, you must learn to understand and respect the budgeting process. The budget people are not an army of bureaucratic, bean counters, but they are, after all is said and done, the enablers, the live-or-die, life-blood of your organization.

In our next issue of *Personnel Notebook*, we will look at preparing the master budget as we continue to review skill number 13, "Mastering Financial Tools," and at understanding the financial statement.

Bill Cook
Human Resource Associates
E-mail: wcook62@comcast.net