

Budget Setting Skills

Budget Setting Skills

Preparing and Setting Budgets

These learning resources can be used as part of a training programme or for self development

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Introduction

These learning materials have been designed to be used either as part of a trainer led session or as a self development tool. They give both underpinning knowledge and encourage the practical application around budget setting using the slide presentation, activities and exercises.

The aim of this budget setting package is:

To assist in raising the financial awareness and competency level in the area of budget setting.

The objectives are to provide:

- Assistance in the development of a comprehensive underpinning knowledge about budget setting principles
- An understanding of the budget setting process and the budget setting techniques that can be used
- Examples of the different types of budget drivers that may be applicable to budget setting
- Opportunities for the practical application of budget setting techniques and processes using activities and exercises

What is a Budget?

- **A financial plan over a period of time**
- **A financial resource allocation of the business plan**
- **A set of financial targets for income and expenditure within the budget timeframe**

Self Development Activity/Exercise

- **Over what length of time do you undertake your financial plan?**

- **Review your business plan and identify whether or not the budget is linked to it. If so, how does it relate in a practical way to the business plan objectives? If not, state what changes need to be made in order to establish a clear relationship between the two.**

- **Identify the relevant financial targets you have for your area in respect of expenditure and income (if relevant). Are the budgets that have been set realistic? If not, what changes need to be made?**

Budget Setting is Important

- 🌐 **Because of the need for**
 - 🌐 **Good Management**
 - 🌐 **Public Accountability**
 - 🌐 **Monitoring Requirements**
 - 🌐 **Decision Making**
 - 🌐 **Financial Resource Allocation**
 - 🌐 **Target setting (income and expenditure)**

Exercise

List 6 other reasons why budget setting is important	
1	
2	
3	
4	
5	
6	

For suggested solutions see pages 19 onwards

Budget Setting Techniques

The two most popular techniques are:

Incremental Budgeting

Last year's figures +/- inflation

- Driven by past activities, therefore backward looking
- Suitable for some areas such as salaries

Zero Based Budgeting

All figures developed from first principles based on realistic assumptions

- Driven by objectives
- Can be time consuming, ideal for new projects and activities

Self Development Activity/Exercise

State, or find out, what budget setting technique has been used when setting your budget.

Undertake the following exercise

You are the manager of an existing training department. The budget for salaries is £120,000, accommodation costs are £60,000, other materials and so on are £20,000. The cost of each course run is £1,000 including trainers fees, and refreshments. Last year 100 courses were run. Inflation rates to be used for budget preparation are 5% for salaries and 3% for all other costs. The objectives in the business plan suggest that the training department should increase courses by 20% and engage a new trainer on £30,000 per annum to deliver courses in-house reducing the cost of courses by an average of £450 per course.

Prepare a budget using the incremental technique?

Now prepare it using the zero based technique?

Consider the difference and how might that effect the way in which you set your budgets in future

For suggested solutions see pages 19 onwards

Cash Limited Budgets

- **Departments are given cash limits within which budgets must be set**
- **It is important that total net expenditure stays within budget for the department and the cash limit not exceeded**
- **This may require movements in budgets during the year by way of virement (an equal and opposite move of funds from one budget heading to another)**
- **Many public sector organisations set budgets in this way**

Self Development Activity/Exercise

Using the information from the exercise on the previous page. Assume you have been given a cash limited budget of £300,000. How would you make changes to the budget (use the zero based technique), and how might this effect the objectives for the year.

(Clearly identify the assumptions being made)

For suggested solutions see pages from 19 onwards

Budget Drivers

- These are the factors that drive income and expenditure such as the number of clients, number of hours worked, number of staff, number of documents to be processed, and so on
- Setting budgets realistically requires a good understanding of the key elements that drive the budget – i.e. drives expenditure or income
- The budget drivers should be used as a basis for budget assumptions
- Assumptions should be made for every area of expenditure and income

Self Development Activity/Exercise

Examine your budget, or a budget from your department and identify 6 areas of expenditure or income for which you are able to list the budget drivers which should affect the setting of those budgets. (there may be more than one driver for a particular expenditure or income category)

1
2
3
4
5
6

Budget Setting Assumptions

- **Each figure within the budget should have an underlying assumption behind it which should be:**
 - **clear and realistic**
 - **linked to a budget driver where possible**
 - **challenged and justified**
 - **well documented, usually in the form of working papers**
 - **monitored against actual performance and outcomes**
 - **understood (if not produced) by the budget holder**

Self Development Activity/Exercise

Describe how each of the 6 bullet points above apply to the assumptions behind your budget (If you do not have a budget discuss this issue with a budget holder in your department)

1

2

3

4

5

6

Budgeting -V- Costing

- **Budgeting usually looks at total expenditure over a period whereas costing looks at the expenditure per unit of activity**
- **Both budgets and costs should be based on the drivers for income and expenditure**
- **Costing requires a knowledge of productivity/output as well as the inputs**
- **Both budgets and target unit costs should be monitored and reviewed**

Exercise

Using the example on page 6 what additional information would you need if you were to adopt more of a costing approach to the budget setting in this case

For suggested solutions see pages 19 onwards

Calculating Unit Cost

The most simplistic approach to activity based costing is to establish a unit cost by dividing the total cost by the volume of activity. For example:

Total cost of providing a school per annum	
£1,500,000	
Total number of pupils	
1,000	
Cost per pupil (unit cost)	
£1,500	

Exercise

Calculate the unit cost of a training course with the following information.

Each course has an average of 10 participants, and one trainer at a rate of £800 per day. They are on average one day in duration and require one room at a rate of £200 per day. Every course provides refreshments at a rate of £10 per participant for tea/coffee/lunch. Annual overheads that must be absorbed are £60,000 and there are 200 courses per year.

For suggested solutions see pages 19 onwards

Activity Based Budgeting

- This incorporates the use of budget drivers and unit costs as the basis for developing the budget.
- Budgets are set for particular activities rather than for business units
- Activity based budgeting is particularly useful for services that require a customer focus

Self Development Activity/Exercise

Given the previous sections, map out how you could approach activity based budgeting in your area, and state what your information requirements might be.

Budgeting for Salaries

- All filled posts should be budgeted for at the actual salary including expected increments, pay awards and any additional payments
- Vacant posts should be estimated at “market value”. The level at which the post can be realistically filled with the correct calibre of staff
- Expenditure on temporary or agency staff should be analysed separately and budgeted on the basis of expected usage – which then becomes a target
- Sensible estimates should be made with respect to the time expected to fill vacant posts and the amount of temporary cover required during the vacant period

Self Development Activity/Exercise

- Describe how budgets for salaries are set in your budget or for your department
- Do they follow the above points of good practice?
- If not, could the budget setting for employees be improved, and if so how?
- Over what length of time do you undertake your financial plan?

Demand Led Budgets

- The expenditure on some services are dictated by demand, and these are more difficult to budget for
- This does not mean that meaningful budgets cannot be developed
- Budgets should be based on reasonable activity assumptions such as client numbers, joiners, leavers, users, etc.
- Actual demand can then be monitored against the assumed demand and budgets reviewed throughout the year

Exercise

The fire service is a demand led service. Not only do they always have to respond to the callouts presented to them from users, they also have to meet quality targets such as response times.

Given the unpredictability of the service and the fluctuation in demand levels year on year, how would you go about setting the budget, and what information would you need?

For suggested solutions see pages 19 onwards

Profiling Budgets

- Most budgets cover a specific time period, usually 12 months, and should be planned accordingly
- The profile reflects the planned occurrence of income and expenditure over the budget timeframe
- The basis for the profile needs to be realistic such as past performance, seasonal fluctuations, contract payments, future planned expenditure, demand trends, etc.
- Demand led services should also be profiled
- Dividing the budget into equal monthly portions (e.g. twelfths in the case of a one year budget, is not adequate in most cases)

Self Development Activity/Exercise

- If a budget for £600,000 is profiled equally over a one year period, what level of budget is allocated to each month?
- What is a common term for this type of profile?
- If the service spends 50% of the £600,000 budget in month 7 of the year, and 25% of the budget in each of the two final months, what should the profile be like, i.e. what budget should be allocated to each of the 12 months?
- What type of profile does your budget have, and does it match the pattern of spend (or income) over the year?

For suggested solutions see pages 19 onwards

Forecasting Income

- **Setting income targets (budgets) can be very difficult as they depend on demand from third parties**
- **Income forecasts should be developed based on the most prudent assumptions by looking at the following:**
 - Existing purchasers
 - Potential purchasers
 - Likely future demand levels
 - Pricing policies and the effect on demand
- **Remember an underachievement of income targets has the same impact as overspending on expenditure budgets**

Self Development Activity/Exercise

- **If you have an income budget, or your department receives income of any kind, consider each of the points mentioned above and state whether or not the income forecast is achievable. Justify your answers, and identify any assumptions that have been made.**

Key to Successful Budgeting

- Define objectives (should be in the business plan)
- Specify actions needed to achieve objectives
- Where possible identify the cost of the actions accurately, stating assumptions made – guesswork should be kept to a minimum! Use budget drivers
- Use figures required to deliver each activity, including overhead costs, to prepare budget
- Review budget for duplication and efficiency, challenge and justify all figures
- Revise budgets if necessary, particularly in light of constraints, such as cash limits
- If constraints cannot be met and further changes are required, first review the cost of the actions, then the actions themselves, then finally review objectives
- Always remember to document how the budget was set such that it can be monitored

Set yourself an action plan to assist in improving the budget setting processes and techniques used in your area

Objective/Target	Actions	Timescale

Further Reading

Further information can be gained from reading the following titles which form part of the FCI System.

Managing the Devolved Budget

You can order this by following the instructions in the “books” section of the system when you log on.

Suggested Solutions to Exercises

Please note that the suggested solutions given below are often one of several possible answers. They have been presented in order to give participants a logical approach to responding to the exercises given. These exercises are very much developmental and thought provoking and hence there may be more than one approach that can be adopted.

If this material is being trainer led, the trainer may indicate the solutions that are most appropriate

Budget Setting is Important

List 6 other reasons why budget setting is important

- It may be a statutory requirement for some public bodies, e.g. a local authority has to set a budget for Council Tax purposes
- The production of management accounts
- Long term planning
- Performance indicators
- As part of internal control, e.g. authorising expenditure within a budget
- A management tool used to run the service and deliver the objectives

Budget Setting Techniques

You are the manager of an existing training department. The budget for salaries is £120,000, accommodation costs are £60,000, other materials and so on are £20,000. The cost of each course run is £1,000 including trainers fees, and refreshments. Last year 100 courses were run. Inflation rates to be used for budget preparation are 5% for salaries and 3% for all other costs. The objectives in the business plan suggest that the training department should increase courses by 20% and engage a new trainer on £30,000 per annum to deliver courses in-house reducing the cost of courses by an average of £450 per course.

Prepare a budget using the incremental technique

Salaries base budget	£120,000
Inflation at 5%	£ 6,000
Other costs (100 courses @ £1,000 + Accommodation and other)	£ 180,000
Inflation at 3%	<u>£ 5,400</u>
Total Budget	<u>£ 311,400</u>

Now prepare it using the zero based technique

Salaries base budget	£120,000
New trainer salary	£ 30,000
Inflation at 5%	£ 7,500
Other costs (120 courses @ £1,000 + Accommodation and other)	£ 200,000
Less: savings (120 courses @ £450)	£ (54,000)
Inflation at 3%	<u>£ 4,380</u>
Total Budget	<u>£ 307,880</u>

Cash limited budgets

Using the information from the exercise on the previous page. Assume you have been given a cash limited budget of £300,000. How would you make changes to the budget (use the zero based technique), and how might this effect the objectives for the year.

(Clearly identify the assumptions being made)

Assumptions:

- Accommodation costs are fixed
- Materials and so on are variable and can be reduced by 10% by improving procurement methods and efficiency
- The objective will have to change and courses only increase by 10% due to the cash limit constraint

Salaries base budget	£120,000
New trainer salary	£ 30,000
Inflation at 5%	£ 7,500
Other costs (110 courses @ £1,000 + Accommodation and other costs Down by £2,000)	£ 188,000
Less: savings (110 courses @ £450)	£ (49,500)
Inflation at 3%	<u>£ 4,155</u>
Total Budget	<u>£ 300,155</u>

The £155 planned overspend should be managed downwards during the year to come in on the cash limit.

Budgeting -v- Costing

Using the example on page 6 what additional information would you need if you were to adopt more of a costing approach to the budget setting in this case

Number of participants and per head cost of refreshments

Detailed cost of trainers (e.g. daily rates)

Cost per day of the accommodation

Level of fixed overhead costs and the cost recovery rate

Historic performance of budgets versus actuals

Historic operational data such as number of courses, participants actually attending, etc.

Calculating Unit Cost

Calculate the unit cost of a training course with the following information.

Each course has an average of 10 participants, and one trainer at a rate of £800 per day. They are on average one day in duration and require one room at a rate of £200 per day. Every course provides refreshments at a rate of £10 per participant for tea/coffee/lunch. Annual overheads that must be absorbed are £60,000 and there are 200 courses per year.

Refreshments	$10 \times £10 = £100$
Overheads	$£60,000/200 = £300$
Trainers	£800
Room	£200
Cost per course	£1,400

Demand led budgets

The fire service is a demand led service. Not only do they always have to respond to the callouts presented to them from users, they also have to meet quality targets such as response times.

Given the unpredictability of the service and the fluctuation in demand levels year on year, how would you go about setting the budget, and what information would you need?

Information needs:

- Historic trends of call out data, budget data, overspends, etc.
- Seasonal or area variations
- Prevention strategies
- Current business plan, and targets for the service

Budget setting process:

- Link figures to operational objectives and targets
- Establish contingency planning to take account of unforeseen changes in demand
- Undertake scenario plans and risk assessments to “predict” likelihood and impact of a variety of scenarios which may affect the service
- Set budget based on budget drivers, knowledge of activity costs, and clear assumptions

Profiling Budgets

- If a budget for £600,000 is profiled equally over a one year period, what level of budget is allocated to each month?

£50,000

- What is a common term for this type of profile?

Straight line

- If the service spends 50% of the £600,000 budget in month 7 of the year, and 25% of the budget in each of the two final months, what should the profile be like, i.e. what budget should be allocated to each of the 12 months?

Month	1	2	3	4	5	6	7	8	9	10	11	12
	0	0	0	0	0	0	300K	0	0	0	150K	150K