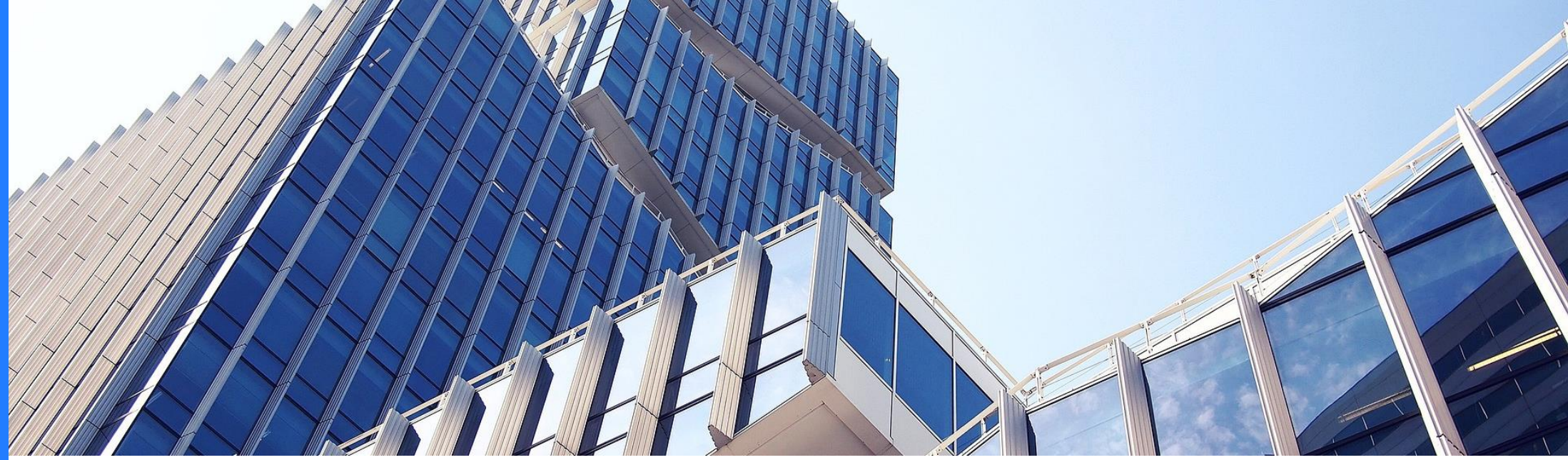


Introduction to budgeting in practice.

Financial modelling, Budgeting and Analysis (FMBA) Training
June to September 2024

Presented by Israel Usidamen

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Brief profile of the facilitator



Israel Usidamen

- Practiced audit for about 8 years before joining the industry.
- Former Financial Controller at listed downstream oil and gas company
- Currently leads the Finance Dept of another downstream company O&G Company (not listed).
- Prize winner with **Institute of Chartered Accountants of Nigeria (ICAN).**
- Teaches financial and corporate reporting at Wyse Associates Limited.
- Co-Founder at Accounting Yard, a brand that seeks to bridge the gap between practical accounting and theoretical accounting.

Introductory concepts

What is a budget and why is it important?

(To be discussed in class)

Key budget preparation steps

1. Create long-term plan (LTP)

2. Prepare annual budget within the context of the LTP.

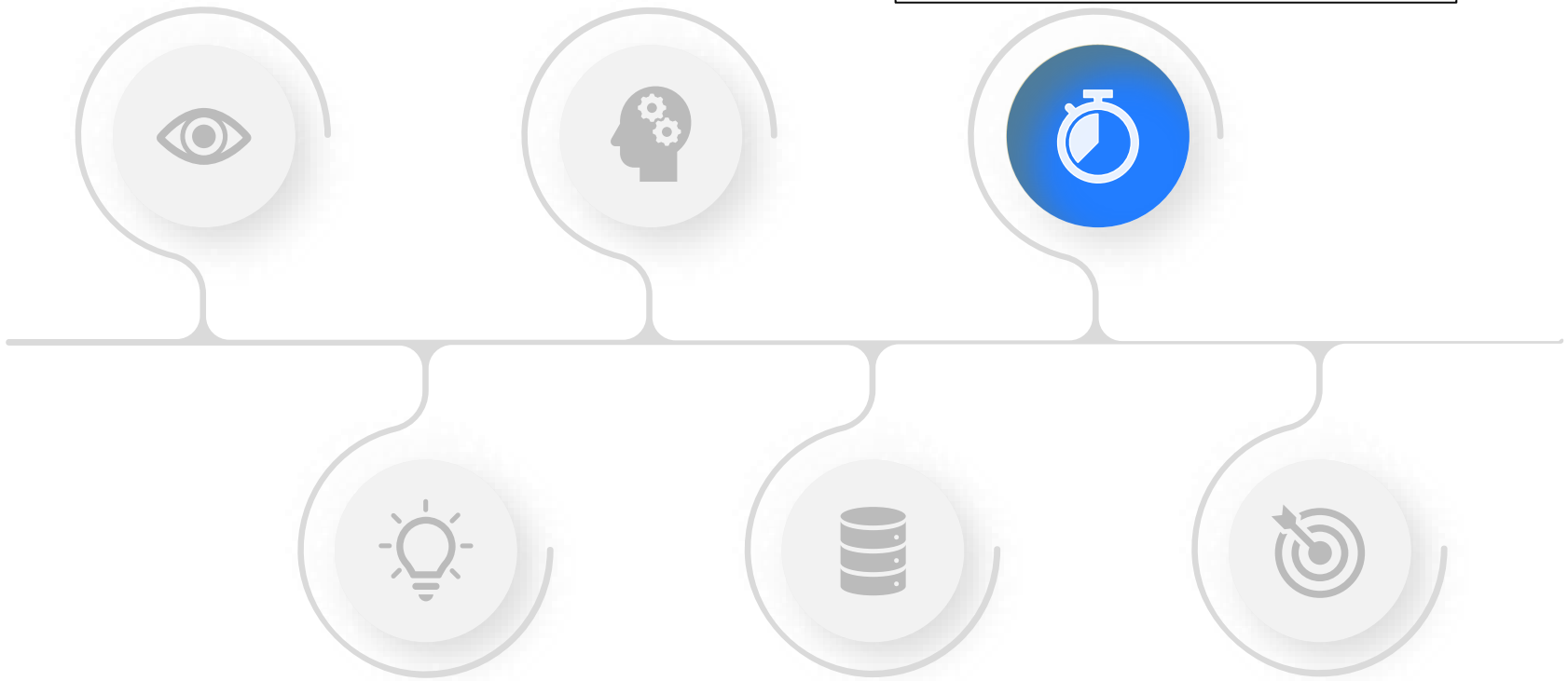
3. Gather data for sales and departmental budgets

4. Integrate budget into a master budget

5. Approve budget & communicate to departmental HoDs

6. Continuous budget review against actual performance

Data is gathered through meetings/ regular discussions with the various HoDs and an eventual budget defense.



Class Discussion

- Do you have a personal budget and how do you go about it?

- If your personal budget reveals that your income is lesser than your expenditure, what will you do?

- Do you have personal plans to build your asset and what plans are they?

- When you prepare personal budgets, do you really take time to compare your budget and your actual spendings?

- Lotana Plc is into the production and sale of cans used by beverage companies. Within the industry, a price war is brewing between two top competitors who are expected to suddenly start selling cans at ridiculously low prices below cost per can. The price war is expected to heighten from February to March 2025.

We are now in December 2024 and you have been told to revise the Company's 2025 budget to consider this imminent price war, what are the likely plans you will put in place in your budget to limit/cushion the impact of the price war on Lotana Plc?

- What are the steps involved in budgeting?

Approaches to budgeting

Approaches to Budgeting – Bottom-up Approach

Top-down approach

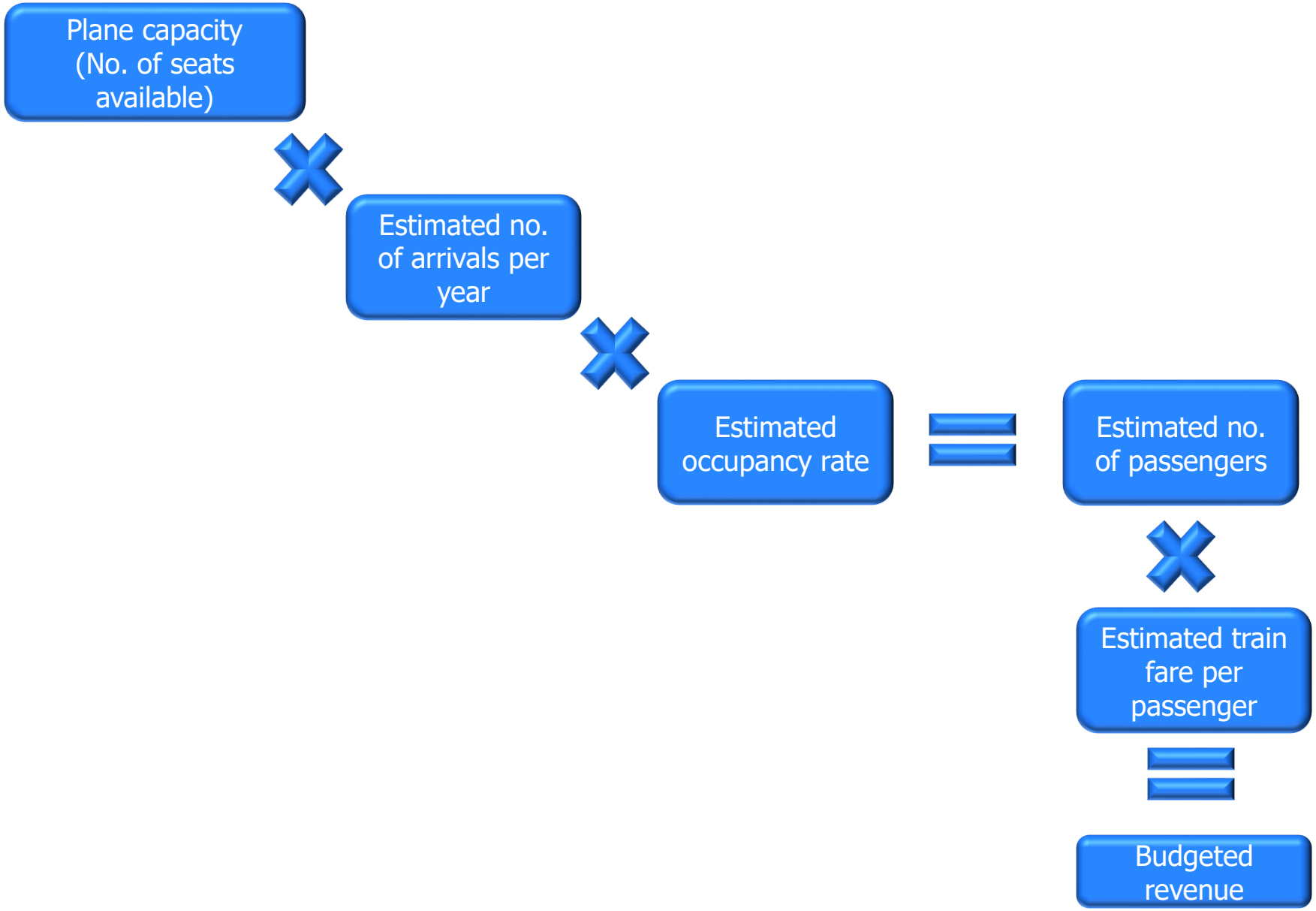
- Senior management prepares a high-level budget for the company with little or no input from departmental managers and then passes it on to department managers for implementation.
- It can be used:
  - With certain strategic KPIs like sales, EBITDA etc.
  - If dept. managers are perceived to lack experience with budgeting.
- High-level variables which form the starting point are usually obtained from the macro/external environment.

Finance must look to balance both views to ensure top-down inputs considers operational needs and departmental targets are in not disconnected from company-wide strategy

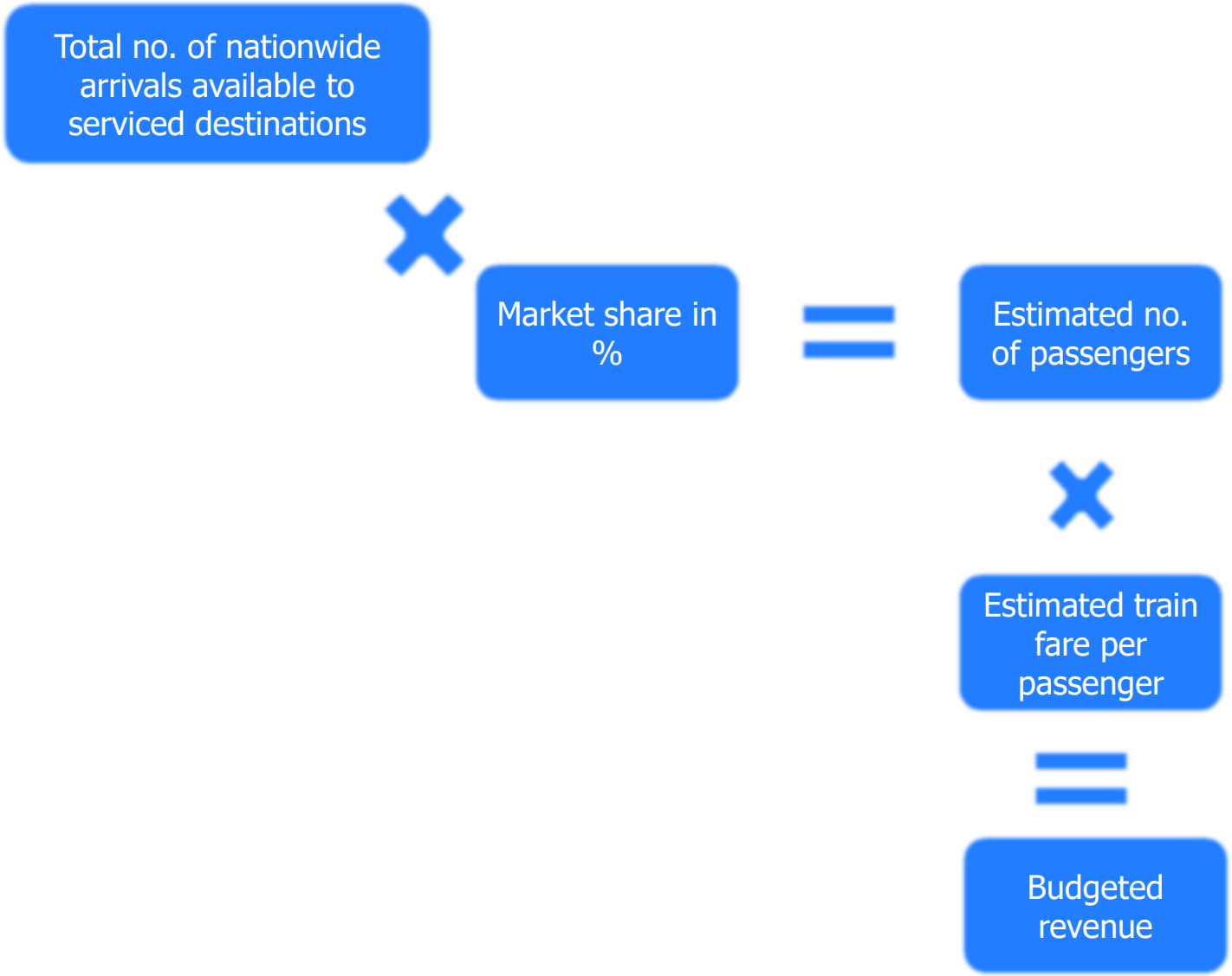
Bottom-up approach

- Individual units set financial goals.
- Focuses on detailed planning at the departmental level. Inputs are largely driven from micro environment obtained from internal data.
- Allows for intense company-wide participation.
- May be time consuming.

Approaches to Budgeting – Bottom-up Approach



Approaches to Budgeting – Top-down



Class Discussion

- In 2022, the Company's staff cost was N20m for the full year. After discussions with the HR Director, you learnt that there is an approved plan to recruit 4 more staff in 2023.

What approach will you take to forecast the staff cost for 2023?

- Company KKL deals in bread. Within the country which Company KKL operates, the price of bread is largely driven by general inflation rate and FX rate. The average prices of bread for different loaves in 2023 was N300, N500, N1,000.

How can Company KKL go about forecasting the price of bread in 2024?

What is the possible bottom-up approach that can be used to forecast the price in 2024?

If inflation is estimated to be excessively high in 2024, how can Company KKL plan its pricing without necessarily affecting sales volume?

Budgeting methods

Incremental Budgeting (IB) (a.k.a traditional or conventional budgeting)

- IB takes last year's actual figures and adds or subtracts a percentage to obtain the current year's budget.
- It is appropriate to use if the primary drivers do not change from year to year.

Pros

- Easy to understand. Most common.
- Easy and quick to implement/prepare.

Cons

- Encourages inefficiencies.
- Excessive opportunity for budgetary slack.

Basic example: Incremental Budgeting

	Actual 2023 balances ₦'000	Est. rate of change %	2024 Budget ₦'000
Sales	100,000	25%	125,000
Cost of sales	(70,000)	30%	(91,000)
Gross profit/(loss)	**30,000**		**34,000**
SG&A	(7,800)	30%	(10,140)
Operating profit / (loss)	**22,200**		**23,860**

% may be based on different factors ranging from management's plan to expand market reach, improving factory/production capacity, change product mix etc.

% may be driven by planned increase in production/sales quantities, inflation, change in product mix etc.

Sometimes, line items may be estimated to decrease, hence, a decremental rate will be applied.

Activity Based Budgeting (ABB)

Intro

- Here, a company sets an output target (e.g., ₦100 billion in revenues).
- Next, the company will need to determine the activities needed to be undertaken to meet the sales target.
- Finally, the costs of carrying out these activities is estimated.
- Compare estimated resource requirements and costs with the current levels for the purpose of identifying cost saving opportunities.

Pros

- Helps with cost cutting.
- Improves cross-departmental collaboration.
- Facilitate resource allocation
- Allows management more control over the budget.

Cons

- More time consuming
- More costly to implement.

Basic example

ABB
Company A anticipates receiving 10,000 sales orders in the upcoming year, with each single order costing ₦1,000 to process. Therefore, the activity-based budget (ABB) for the expenses relating to processing sales orders for the upcoming year is ₦10,000,000 (10.000 x ₦1,000).

Conventional budgeting
If ₦9 million was actually incurred last year on sales order processing and sales were expected to by grow 25%, only ₦11.25 million (₦9m + (₦9m x 25%) is budgeted.

Zero Based Budgeting (ZBB)

Intro

- Projected expenditures for **existing activities** should start from base zero rather than last year's budget or actual.
- Every departmental expenditure is reviewed comprehensively. Managers must justify all expenditures.
- Key questions asked:
  - Is the activity necessary at all?
  - What happens if the activity ceases?
  - Is the current level of provision adequate?
  - Are there other ways of carrying out this activity?
  - How much should the activity cost?
  - Do the benefits to be gained from the activity match the cost?

Stages

- Managers identify expected activities/programmes to be carried out next year. Activities are described in a document called **decision package (DP)**
- All the DP is then ranked all the in the order of decreasing benefits to the organization.
- The resources are then allocated based on order of priority up to the spending level.
- Typical content of a decision package (DP):
  - analyses the cost of the activity
  - states its purpose
  - identifies alternative methods of achieving the same purpose
  - establishes performance measures
  - assesses the consequence of not performing the activity (partially or fully).

Pros

- Helps with cost cutting as prior year's waste is not carried forward.
- Since it follows a bottom-up approach, it allows for employe participation.
- Helps with responding to the business environment.
- More efficient resource allocation.

Cons

- Maybe time consuming especially for large organisations.
- Managers may require training to develop a DP.

Class Discussion

- Which of the approaches does ABB apply?

Top-down? Bottom-up? Both?

- Incremental budget follows which approach?

- Which budgeting method is the most popular?

Revenue modelling

Sample revenue model for different industries

- Installed Capacity
- Utilization
- Sales/Production Mix
- Seasonality of business
- Price per product/Price per product per customer
- Customer Mix

Manufacturing

Sample revenue model for different industries

Number of Truck / Vehicle

Number of trips in week per month

Price per trip / Price per passenger

Vehicle Capacity

Haulage and Transportation

ACCOUNTING YARD

Deposit

Loan to Deposit ratio

Average pricing of a facility

Average deposit per customer

Financial Service

CLASS DISCUSSION

Can anyone in the class share their knowledge of any revenue/business model they have experienced?