

November 6, 1995

**Paul Juras, Financial Vice President
Snorek Prototype Research, Inc.
5800 Moravia Road
Winston-Salem, NC 27127**

Dear Mr. Juras,

In response to your request for advice regarding the implementation of a complete budgeting system for Snorek Prototype Research Inc., here follows some useful information, and some considerations that I think should be addressed.

A complete budgeting system is implemented when the planning and control functions in an organization are achieved by managers who outline detailed plans for the acquisition and use of all the resources in an organization. This means that detailed estimates of future expenditures, for instance, will be needed not only for items such as land, building, and equipment (a capital budget), but also for operational expenses, such as advertising, supplies, salaries, materials, etc. A complete budgeting system provides management with a truly global perspective on all the company's activities, because a detailed budget exists for all types of resources (including nonfinancial resources, such as the passing of time that depreciates assets), that are acquired and consumed in a given time period.

Just like individual budgets provide information that can be used for both planning and controlling the acquisition and the use of resources in particular areas, similarly the whole budgeting system can be used to plan and control the overall company's performance. In performing this task, managers refer to a master budget. A master budget is a network consisting of all the individual budgets for the company's activities, which are all interdependent. In order to prepare a master budget, managers go through the sequential development of the single budgets that are part of the system. A sales forecast for the entire industry is usually the starting point for estimating the company's future sales. The sales budget then triggers a chain reaction that leads to the development of all the other budgets. The reason for this is that estimated sales data are necessary for determining other estimates, such as the level of production, which, in turn, will help determine other budgeted figures, including material or inventory purchases, direct labor, and overhead expenses. The sales budget is also critical in that, for many organizations, sales are the only source of income. This means that the primary way that the organization can acquire resources is by using the cash that came from the sales. After all the other operating budgets have been established, the cash budget can be prepared, so that management will know whether or not the cash inflow from operating activities will be sufficient for covering all the planned outflow, and related financial decisions can be made. The final step of the budgeting process would then be to prepare budgeted financial statements.

In regard to Snorek, given the service nature of the business, I would suggest the use of the following for putting together an annual master budget: 1) a sales budget, taking also into account the impact of advertising expenditures, and containing a schedule of expected cash collections; 2) a cost of service budget, that will essentially estimate the amount of resources that will be directly consumed in providing the expected amount of service sold (this should also include a schedule of expected cash disbursements); 3) a capital budget, that will be based on a long-term sales forecast (this should also provide a disbursement schedule); 4) a selling and administrative expense budget, for the anticipated level of activity, separating cash expenditures from noncash expenditures; 5) a detailed cash budget that takes into account 1, 2, 3, and 4; 6) budgeted financial statements.

If the master budget network described above is going to be implemented in your company, one of the most apparent immediate benefits will be a greatly increased reliability of the cash budget. The cash budget currently in use is based solely on a general sales revenue forecast

and on the capital expenditure budget. Those two estimates alone fail to provide management with a realistic perspective on cash flow, since many significant items, such as salaries, supplies, advertising, and various production and administrative expenses are not considered. It appears to me that the current budgeting system in use at Snorek Prototype Research Inc. is far from being complete and reliable, and I would recommend adding all the other budgets to the system as soon as possible.

In doing so, and in implementing the complete budgeting system, you might want to consider a participative approach, where middle and lower managers prepare their own budget estimates. This type of approach may be more effective than "top-down" imposed budgets, considering the large number and the high level of competency of your professional employees.

If you have any questions about these and other issues relating to your budgeting system and to the growth of your company, please feel free to call me.

Sincerely,

Christian Cappelluti
Independent Consultant

Christian Cappelluti (independent consultant) confesses

I have to admit that budgeting for service companies is not my specialty. Actually, I am not familiar with accounting for service companies at all. I went back to my college accounting textbook, but I could not find anything that specifically addressed budgeting procedures for service companies. The explanations and observations that I offered in my letter to the financial vice president of Snorek Prototype Research Inc. were primarily based on my knowledge of budgeting for manufacturing and merchandising companies. I really hope that service companies do not adopt specific budgeting procedures (or terms) that are substantially different from the ones used by manufacturing and merchandising companies because, if they do, I certainly do not know anything about it.