Case Study – Budgeting and Forecasting Model

Executive Summary

Budgeting, financial modelling and the power of knowledge

“Our monthly results are in and again we have a declining bottom line. Our volumes are increasing in a declining market, our factories are running near capacity but the business is going backwards. This is unacceptable; it can not be allowed to continue. We need to do better, we must do better and we will do better.”

In Mid 2005 a medium size manufacturing firm in Newcastle found itself in the position of declining profits in the face of increasing sales volumes. The organisation consisted of four operating entities with various factories located around the country. Three of the entities operated Australia wide while the fourth operated primarily in the Sydney, Newcastle and North Coast markets.

The CEO of the organisation was an engineer. As such the four operating entities were managed with an emphasis on product quality and efficiency. Operations were streamlined with very little fat in the production process.

One of the entities in the group was a manufacturing plant located in Queensland supplying quality products, Australia wide, to the building industry. In early 2005 this entity found itself in a market that was in a cyclical downturn coupled with increasing competition flowing in from China and local competitors desperate to maintain their market share.

It was increasingly clear that moving forward the entity faced a significantly different environment from that of the past and a strategy to adapt to the changing environment was required.

Senior management met and decided on a strategy of increasing the volume by hitting the low end of the market with a low cost product containing basic functionality. It was determined that demand for this product would increase our volumes close to the operational capacity of the factory and thus fully utilize our fixed cost structure flowing through to a lower unit cost. To achieve this target the sales and marketing team, the whole front end of the business needed to hit the market place hard.
Background

“Our Queensland operation is in a bit of trouble. It has been a strong performer for a long time now but the water level is rising and we need to stay ahead of it. This is the strategy that will return the Queensland operation to a position of strength, to the place it deserves. But we need to move fast so make it happen.”

A design was rapidly developed and implemented into the operating process. While the operational kinks were being ironed out the sales team were beating down doors and building up support for the product in the market place.

In a very short time the product was rolling of the factory floor. The market place was snapping the product up and very soon the factory had reached its capacity.

In a very short time the product was rolling of the factory floor. The market place was snapping the product up and very soon the factory had reached its capacity.

Management were enthusiastic about the roll out of the strategy and eagerly awaited the first clean full month of results.

When the first month of results come in the business was no longer just keeping its head above water in was showing a significant loss. After the next months results showed a similar, if not worsening result SME Results Group were brought in to advise on the situation.

After a short, intensive investigation phase SME Results Group reported back to the board on its findings. It was found that the current performance of the organisation was being largely driven by two issues.

Challenges Faced

Firstly the intensive push by the organisation towards the low cost high volume product resulted in a shifting of the product mix in effect eroding or cannibalising our premium high margin products.

Secondly, the costing of the new product was in effect developed using a marginal costing technique. Under this technique all of the fixed costs or overheads of the business were not incorporated in to the products produced. The new product mix coupled with the marginal costing effect resulted in an artificially low unit cost which was then used to set the price in the market place. What was seen by the organisation as a high volume low margin product was in fact, under the new product mix, a zero to negative margin product.

SME Results Group then presented to the board a solution to not only facilitate the development of a strategy to turn the company around but to also provide a solid information platform for future decision making.

“Its not that we need to do it better, we need to do it smarter. We need to prioritise the use of our resources, focus our attention on areas that will maximise the benefit or value adding derived from them.”

The solution was to develop and implement a fully integrated and comprehensive budgeting and forecasting model with a powerful “What If” or scenario generation
capacity. At the boards request SME Results Group then embarked on the project.

After extensive consultation with all the stakeholders a clear understanding of user requirements and key outcomes was generated and a model to meet those requirements was designed. The model consisted of a number of modules, each of which had a data processing function, an operational reporting function and a user interface data entry function.

Using Excel as a platform the modules were then developed with an emphasis on access security, user friendliness and report readability. The interface between the modules was then developed to culminate in the building of a high level reporting module.

Once the model had been developed and extensively tested it was then rolled out through the organisation.

The sales team developed a budget in greater detail than they had in the past. This initiated a thought process into what product line we can target and what can realistically be achieved in the different market segments for the different product lines.

This led into a production volume requirement and gave our operations managers more reliable information to plan their production runs and procurement managers greater information to negotiate solid fixed contracts and take advantage of reduced supply costs of materials.

Managers were then tasked with reviewing their costs in detail and forecasting what those costs would be over the following 12 months. These were then reviewed with senior management and agreements were reached.

With this information as inputs a more robust and reliable standard cost was developed for each of the products.

After interfacing the modules management was then able to review a forecasted profit and loss for the entity over the next twelve months as well as a balance sheet and cash flow. Also of keen interest to management was the analysis around the margins of the different product ranges offered.

Senior management then used the model to engage in an extensive round of what if analysis primarily around the product mix to determine what the optimal mix would be while utilising the full capacity of the factory.

This resulted in a product rationalisation program as well as the development of sales KPI’s to focus our sales peoples attention on the product ranges and markets we strategically wanted to be in.

The end result of the process was to revisit the budget with the vision of strategically were we wanted to position the business. While the CEO was up to his nuts in the hindoquarters of a potty calf various strategies were then developed within the business units targeted at achieving the budget result.

Once the budget model had been designed, developed and implemented throughout the business the board then engaged SME Results Group to design, develop and implement a comprehensive monthly reporting structure of actual performance to budget heavily focused on the key levers and
drivers of the business. In essence a highly targeted small number of KPI’s for each business unit were designed based on their sensitivity to the bottom line result.

Guys’, working smart is the key. We need to focus our efforts, our resources into the key areas that will drive our business into the future. The playing field is a lot tougher now. What worked for us in the past may not work for us in the future. We need to be in front of the ball. I don’t want our efforts, our resources wasted on areas that won’t enhance the value of our company.

At the start of the 2006 year the company had embarked on a bold new strategy to not only reposition itself in the marketplace but to also transform its core values.

In a very short space of time the company experienced a shift of its product mix back towards the high margin end of its mix. Orders for the high volume low margin product were still coming in but the focus of the factory was directed elsewhere and the lead time for this product began to grow. While an adverse impact in the market place was felt because of this, our products were sufficiently segmented to not have a significant impact. In time demand began to fall away and a more robust profitable product mix began to emerge.

On the cost side of the business a 4.6% decrease in the cost of raw materials was achieved due to a more reliable ordering pattern and fixed contract structures to preferred suppliers.

Factory costs also realised a cost savings as a result of a higher awareness through more rigorous reporting.

The company today not only enjoys a prime spot in the market place, as it has done for many years, it is also in a much stronger fiscal position to ride out the current downturn in the building industry and to launch into the market when the cycle turns with renewed vigour and energy.

SME Results Group currently enjoys a strong relationship with this company continuing to provide advice on an ad-hoc basis across a broad range of issues. A negotiation is also under way to roll the budgeting forecasting model out to one of the other companies within the group.

SME Results Group Pty Ltd is an advisory firm specialising in integrated growth strategies and delivery of bringing world’s best management practices to the SME sector.

For a no obligation, confidential discussing of how SME Results Group Pty Ltd can assist you with your company’s future plans contact:

Mr. Scott Varker
m: 0404 278 622
e: savarker@smeresults.com.au