Think Ahead

Menu

All about budgeting – part 2

Rolling budget

Traditionally, budgets are prepared on an annual basis. After the annual budget is approved, it is usually 'set in stone' and not updated during this period. This approach can be useful for controlling a business in a stable, mature industry. However, as many organisations face more volatility and uncertainty, this arbitrary, one-year budget cycle may be too long and unpredictable for forecasts and targets to be meaningful. A lot can happen in one year – competitors can launch new products, consumer demand can change, and costs can fluctuate. This can render the annual budget obsolete.

A solution to this problem is the **rolling budget** approach. This means that the budget will be updated more frequently than annually – either quarterly or even monthly – and a new budget period will be added to replace the expired period. Using this approach, the budget will always extend one year into the future and will be continuously updated.

Pros and cons

The budget should be more accurate as it is updated more frequently, improving planning and control. This approach is also particularly useful in more unpredictable and volatile industries where it is difficult to plan one year into the future. Managers will revise their assumptions on a more regular basis, reducing the element of uncertainty.

However, rolling budgets require more work as managers will need training which is likely to be expensive and time-consuming. Also, conflict may emerge regarding performance targets – managers may complain of, 'changing goal posts'. Managers may also spend too much time preparing the budget, and not enough time controlling. The company may need to acquire new software which allows for regular updating of the budget. If the rolling budget is done on a stand-alone spreadsheet not linked to the company's internal systems, data integrity problems can emerge.

Rolling budget example

Timana Co manufactures small-panel display screens for smartphones, car navigation and other consumer electronic products. This is a competitive industry characterised by short product life cycles, pricing pressure from online retailers and the need to continually innovate. The company has used annual, incremental budgeting, created on a standalone spreadsheet, as their primary control tool and uses this budget as the basis for performance targets for both sales managers and other managers.

The finance director recently attended a conference on 'Budgeting in the Technology Industry' and realised that the incremental budgeting system they have been using is no longer fit for purpose in a volatile industry like technology. He is aware that the budget has to be updated every quarter to take into account the changes in the market. He has therefore suggested that a rolling budget approach is undertaken.

The finance staff have been unhappy about the proposal, claiming that the existing computer system will not support the rolling budget approach and the sales managers were overheard saying: 'What is this rolling budget system and how will this affect our bonuses?'

The following budget has been prepared for the current year ending 31 December 20X8:

	Q1	Q2	Q3	Q4
	$	$	$	$
Revenue	480,000	494,400	509,232	524,509

	Q1	Q2	Q3	Q4
Direct labour	(24,000)	(24,720)	(25,462)	(26,225)
Direct material	(48,000)	(49,440)	(50,923)	(52,451)
Contribution	**408,000**	**420,240**	**432,847**	**445,833**
Fixed production overheads	(120,000)	(120,000)	(130,000)	(130,000)
Administration costs	(210,000)	(210,000)	(216,300)	(216,300)
Profit	**78,000**	**90,240**	**86,547**	**99,533**

The budget was based on the following assumptions:

1. Sales volume would grow at the same fixed compound rate every quarter
2. Direct material and direct labour are wholly variable costs
3. Fixed production overheads would now be $10,000 higher from Q3 onwards as it was decided the machinery would require extra maintenance
4. Administration costs would increase by 3% in Q3 to account for an increase in the rent for the building

The actual results for Q1 were released.

	Q1
	$
Revenue	470,400
Direct labour	(24,480)
Direct material	(48,000)
Contribution	**397,920**
Fixed production overheads	(120,000)
Administration costs	(210,000)
Profit	**67,920**

The sales manager and production manager both commented that the actual results were different because of the following factors:

The sales manager said he had to reduce selling prices to boost demand as the market became more competitive. The decrease in revenue is accounted for solely by changes in selling prices. Sales volume is expected to grow as forecast in the original budget forecast.

The production manager confirmed that the direct labour cost was higher because of an increase in the minimum wage. It was also agreed that in Q3 the direct labour cost will increase by a one-off amount of $5,000 to account for additional training required under health and safety legislation.

The finance director decided to act on the comments he received from the finance team and the sales managers regarding training and the computer system. The first step was to create a position for a 'change manager;' this new manager will start at the beginning of Q2 with an annual salary of $150,000 and the administration cost will need to be adjusted to reflect this.

Required:

(a) Prepare Timana Co's rolling budget for the next four quarters (to the nearest $).
(Note: when preparing the budget the original assumptions are correct and should still be used).

(b) Discuss THREE issues related to the implementation of a rolling budget system in Timana Co.

Suggested solution:

- Question (a)
- Question (b)

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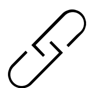

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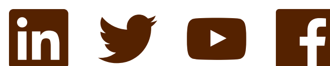

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