

# Money and the Key Aspects of Financial Management

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## Abstract

*In this paper we will briefly present the tools of budgeting, forecasting and variance analysis that are used by successful companies to manage ongoing money capital. Our goal is to give you an overview and enough information to begin using these concepts in your business.*

*Financial Management employs the tools of budgeting, forecasting, and variance analysis to better manage the annual money capital available to business. These tools are very simple to use - it is just a matter of setting standards and consistently using them.*

**Key words:** *financial management, budgeting, forecasting, variance analysis*

## Why is Financial Management Important?

Economics has been used throughout history as a scientific means of studying how to allocate scarce resources. One of the scarcest resources that exist today, especially, in developing countries, is the capital, monetary investments for purchase, maintenance or growth of a company. As such, it is imperative to manage the resources, the available money capital.

Financial Management employs the tools of budgeting, forecasting, and variance analysis to better manage the annual money capital available to business. These tools are very simple to use - it is just a matter of setting standards and consistently using them.

In this paper we will briefly review the tools of budgeting, forecasting and variance analysis that are used by successful companies to manage ongoing money capital. Our goal is to give you an overview and enough information to begin using these concepts in your business. There are many books, internet sites, and software programs that can provide you with more information and tools on budgeting, forecasting and variance analysis.

It is important to note the word “Management” in the phrase “Financial Management”. These are tools for company management and should be designed to be usable and understandable by management.

The type of data budgeted, forecasted, and analysed should be based on financial information that management deems vital for the success of the company and may differ from industry to industry, or company to company.

## Budgeting

Budgeting refers to assessing and planning the allocation of a company's financial – monetary resources for a future period of time, usually for one year. Through budgeting, your company creates future financial goals for every department, project, product, or region, depending on your budgeting method. When companies maintain realistic, accurate budgets, they acquire a financial map that can help the company lower cost and maintain healthier cash flows. In business there are many things hard to control such as inflation, currency devaluation, and recessions. That is why it is vital for companies to control the things that are within their control such as cash flow and cost. Budgeting is the first step towards gaining control of your company's finances and monetary investments.

## Creating a Management Financial System

The first and most difficult step in beginning to successfully budget is designing a management financial system that can provide the financial information needed for creating and monitoring budgets. In budgeting, we begin building alternative management financial records that can be used to set targets and gain valuable insight on the present and projected financial health of the company. Your company's goal is to produce new accounting records that reflect a more realistic management view of the company's finances and monetary investments.

Once a company decides how current financial accounting information will be recorded and reported for Management accounting purposes, a company can decide if additional details and categories of financial data should be collected.

For example, having more detailed information on financial items such as operating costs, what are fixed and variable costs, may create a benefit to management. It may also be a great benefit to management to maintain financial records by categories, such as department, region, product, or project. Such cost details give management better insight into the company's true cost structure. For instance, if total costs were increasing by 30% annually, how would a company know where to begin controlling cost? Would it not help if you knew that costs of a specific product, region, or project were increasing? Maybe the economy of a specific region is experiencing higher inflation than other regions resulting in higher costs that are out of the company's control or may be the supplier in the region is slowly increasing prices and the company should be finding an alternative supplier.

Initial analysis needed for creating a management financial system is very time-consuming, but the resulting Management Accounting system insures that management can quickly assess the real financial health of the company. In the end, you derive two different financial systems with the following different characteristics (Table 1):

**Table 1.** Characteristics of financial systems

<b>Characteristic</b>	<b>Financial Accounting</b>	<b>Budgeting/ Management Accounting</b>
Purpose	External reporting	Internal reporting to management
Perspective	Retrospective	Prospective
Reporting Detail	General	Specific
History	Long past	Relatively recent

One benefit of Management Accounting System is to provide realistic, useful financial information that can be used to create and monitor budgets. This is a benefit that accounting information is not designed to provide. When a company has detailed, realistic financial information for budgeting, it can:

- align projects and activities with organization strategy and business objectives;
- assist management in making better monetary investment decisions;
- assess performance;
- provide early warning of operational problems;
- provide assurance to senior management that its decisions are being implemented as intended.

## **Establishing Financial and Monetary Goals**

Once you have created a management financial system, it is time to set financial and monetary goals for your company's future through budgeting. To begin budgeting, the following steps should be taken:

1. Assign a team to each department, product, region, or project for submitting an annual budget and performing ongoing analysis. Involve people that are closest to the day-to-day operations for each department, product, region, or project. For example, if you categorize your budget by department, who in marketing is submitting expenses to accounting? Possibly that person should also provide input on how such expenses should be budgeted.
2. Decide for what future period of time the company will establish financial and monetary goals. For the next year? For the next two years? The next five? In the past, companies usually budgeted for a period of one year. In a consistently changing environment as Romania, budgeting beyond one year is probably not useful. With the increasing pace of change worldwide, a new concept is arising in the form of rolling budgets, which involves analysing the company's numbers in small sections of time. For example, a company may design a rolling budget so that every month the next 5 quarters are forecasted. At the end of every month, another month is added to the end of the forecast period. For example, at the end of January 2004 you forecast the next 5 quarters, through March 2005, and add April 2005 to replace the January 2004 month that just ended. While this usually involves fewer details (generally revenue and expenses only as opposed to a complete balance sheet, income statement and cash flow statement), it will probably require more work in terms of time. The advantage of rolling budgets is that you deal in reality, not old data that no longer applies to the company. Rolling budgets still require you to complete an annual plan, but they offer a way of doing mid-quarter corrections to the plan.
3. Decide what financial and monetary variables should be budgeted. Which variables will determine your company's success or failure? Such variables may include net profit, total operating cost, cost per unit, total revenue, profit margin, operating cost ratio, etc. A budgeted balance sheet, income statement and cash flow statement are usually created to support budgeted variables. At a minimum, companies should create cash flow and expense budgets as controlling cash flow and expenses is the easiest method of ensuring that the funding needs of a company can be met. Many companies realize there are non-financial – monetary variables that are also essential to their success that should be tracked in budgets such as customer satisfaction, employee satisfaction, and customer retention.
4. Following the first year of budgeting, teams should access last year's actual financial data and determine what data from last year will be repetitive and what was one-time only event. In addition, last year's budget and variances to the budget should be examined.
5. Establish reasonable assumptions about the future, what are future inflation rates, economic growth rates (expansion or contraction), industry growth rates, unemployment rates, currency rates and company growth rates or forecasted sales volume? Business periodicals,

newspapers, and Internet sites are good sources for tracking present economic conditions and future economic predictions by governmental and private institutions.

6. Have each team set reasonable targets for all financial – monetary variables for the future period.
7. Have management approve the budgeted targets.

## **Budgeting Issues**

While designing a management financial system and a budget process, the following *issues* should be considered:

### *Involve everyone from the company*

The ongoing budgeting process provides an opportunity to educate all employees on the present and desired company cost structure. Through the budgeting process and proper incentive programs, many companies have turned their employees into partners in the struggle to control and reduce cost.

### *Budgets need to be flexible*

Budgets have to be flexible, and you need to refresh them as the business changes. The faster your industry moves, the faster your company shifts priorities, more often you have to adjust your plans, and, hence, your budgets. Otherwise, you run the risk of making decisions on outdated data that no longer reflects the reality of the company. Flexible budgets will become more and more imperative as the continuing global and technical evolution of business increases the speed of change.

### *Design a reasonable budget process that allows time for analysis*

Many companies get so involved in collecting the financial data, needed for budget preparation, they have little time for detailed analysis that would add true value to the budget process. Thus, when your company creates its budgeting process, think about what is absolutely needed for monitoring the financial health of your company. Data requests should be limited to what is necessary to gain a complete and useful picture of the company's financial health and financial needs.

### *Management access*

Some finance departments generate many reports to answer every present and predictable management question. Management needs to have fast access to consistent, understandable data that provides them with the information they need for making daily decisions. A successful financial system will provide a useful budget format that allows management to see what they want, when they want it.

### *Reasonable assumptions*

A budget tries to produce a future prediction of a company's financial status. Therefore, assumptions about economic factors, such as inflation, economic expansion or contraction, and currency devaluation, which may affect the company's future, must be accurately predicted. Economic predictions by governmental and private institutions can be found in newspapers, business publications, and on the Internet. Useful budgets include reasonable assumptions that are clearly communicated to all participants involved.

## **Variance Analysis**

Once financial – monetary goals are established through budgeting, it is time to analyze how well a company is achieving its goals through variance analysis. As we have noted earlier, your company's budget provides a financial plan for achieving your company's financial and

monetary objectives for a fixed period of time. However, once your company has implemented that plan, your company needs to know how it is performing in comparison to that plan. This is the purpose of variance analysis.

Periodically, usually monthly or quarterly depending on how quickly business conditions are changing, you want to compare actual financials to budgeted financials. If there are large percentage deviations, above 5%, 10%, or 15% depending on how conservative your company is, you have to analyze and investigate the cause of deviation. This is the time to ask questions. Have economical assumptions, such as inflation, changed? Are the company's competitors forcing it to spend more or price lower than anticipated? Did the company change its strategy forcing a reallocation of planned spending? Is it a permanent change or a temporary change? The important thing is to track and log changes to your budget so that you can prepare better budgets and forecasts in the future.

## **Forecast**

We have already discussed forecasting when we have dealt with establishing financial – monetary goals. At the beginning of every budgeting process, you are forecasting predictable financial variables. Please remember that predictions will never be 100% accurate. However, even rough predictions provide some targets for measuring progress towards, and achieving, short-term goals.

The key to forecasting is to review your predictions periodically, possibly quarterly, based on the results of variance analysis. If variance analysis indicates that actual financial figures differ from budgeted financial figures, a company must predict, or forecast, whether the change will affect the budget.

Differences between actual and budgeted figures could be seasonal or short-term, while full-year actual figures may be forecasted to equal budgeted financials.

For example, when you pay actual office supply expenses could differ from when you thought these expenses would be paid, but the total amount paid for the year will still equal budgeted office supply expenses. If your projections are extremely incorrect, more than 20% off for a quarter, and there is no possibility of still meeting the original budget at the end of the year, changes to the budget should be proposed to management. Maybe you omitted a major expense item in the original budget, discovered a new source of revenue, or realized that expenses are being affected by a percent inflation rate which differs from the government predicted inflation rate, used in your budget.

Thus, forecasting does not stop once you have created your budget. Based on the changing business environment and periodic variance analysis, a company should project whether the original budget can be accomplished.

## **Conclusion**

Whether your company is large or small, its scarcest resource will always be the money capital. The first step towards a healthier and more successful financial future is gaining understanding of how you can better control cost and money capital. This is the purpose of ongoing budgeting, variance analysis and forecasting.

If you are a small company, now is the time to create a management financial system that allows effective budgeting before growth increases the complexity of the task. If you are a large company, it is even more imperative to create a management financial system before spiraling cost and dwindling cash flow cause your company's decline.

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## Banii și aspectele esențiale ale managementului financiar

### Rezumat

*În acest articol se prezintă pe scurt uneltele elaborării și executării bugetului, ale prognozei și analizei de varianță, folosite de companiile de succes pentru a lucra cu capitalul monetar aflat în posesie. Obiectivul autorilor este acela de a realiza o imagine cât mai completă a ceea ce înseamnă management financiar și de a obține suficiente informații pentru a putea utiliza aceste concepte în afacerile companiei.*

*Managementul financiar folosește uneltele bugetului, prognozei și analiza de varianță pentru a utiliza cât mai eficient capitalul monetar alocat pe un an, și, prin urmare, disponibil afacerii. Aceste unelte sunt relativ simplu de folosit, în condițiile stabilirii unor standarde și utilizării lor în mod consecvent.*