**FINANCIAL AND BUSINESS MANAGEMENT FOR ROAD CONTRACTORS**

**MODULE THREE SESSION TWO PARTICIPANTS’ NOTES**

**INTRODUCTION TO BUDGETS**

1. **Session Objectives**
2. To explain a road construction budget and purpose;
3. To show the relationship between business plan and budget;
4. To create awareness of a budget as a tool for financial discipline.
5. **What is a budget?**

A Budget is a detailed annual plan of how much revenue the company will raise and what the business will spend to earn it all in line with the company objectives, goals and priorities. A budget identifies sources of funds such as income, bank loan, issue of shares, grants etc along with their planned uses (expenses), such as labour, materials, overheads, taxation, equipment etc. Budgets are normally for a period of one year although there can be budgets for shorter periods. In case of contracts, a budget can be for the whole contract or an activity within the contract.

1. **Why budget?**

A budget is a document that translates operational plans into money; it shows how much it will cost to achieve the set objectives. Like most business road construction companies havescarce resources which are not sufficient to carry out all its programmes and projects and therefore there must be prioritization and scheduling of activities.

A budget sets the upper limits for expenditure and therefore is a control tool on spending to achievement of goals.

 A budget shows the reality of the market and expected revenues from it. In order to manage competition the owner of the business must keep a close eye on its progress and take corrective action when it is called for. Budget link spending to plans and activity in a work plan and is therefore a plan implementation tool. Budgets serve as control tools to match anticipated and actual revenues and expenditures and identify variances in the plan and costs.

1. **Approaches to budget preparation:**

Construction is project driven. Therefore, budgeting for construction should be on contract by contract basis. The number of construction projects that are available for bidding tends to run in cycles. A construction company has no control over the number of projects it may bid for or the number of projects it will be awarded in a competitive bid environment. So except for ongoing contracts, overall budgeting for a road construction business can really be challenging.

This is why it is imperative that construction companies adopt project budgeting, i.e. budget as and when contract is available. The process will include:

1. Validation of the original financial bid proposal to identify appropriateness and identify any possible need for correction;
2. Project contract revenue per period, monthly and annually or as expected from running contracts. The capacity of the business should be ascertained and discounted for idle periods to estimate the likely total works targeted for the period. For example, if the capacity is 30kms per annum, we may assume a 70% occupancy and budget for 21kms to done during the year (inclusive of works already running);
3. Quantify the direct costs of delivering the budgeted output such as materials, labour, machine time and other direct costs of production.
4. Administration & Overheads **–** indirectexpenses such as management payroll, marketing, rent, insurance, licensing and others;
5. Capital Expenditure – expenses for machinery or automobiles, you plan to use for contract execution whether they will be owned or hired;
6. Where machinery and equipment are owned, subject them to wear and tear over the period of use. Provide for a reasonable expected life of the asset, spread the cost over the life period and charge to the contract the proportionate machine hours or time used on the project;
7. Estimate the cost of borrowed capital such as interest and taxes where applicable;
8. Work out an income statement based on the budgeted revenue and costs. Assess whether the returns meet the targets of the business plan. Then follow with a cash budget by estimating actual cash to be received and the actual cash payments that will be made during a specified period and assess the adequacy of cash flow.
9. Identify any cost saving strategies and any cash flow stabilization measures.
10. Continually review the budget to suit operating environment.
11. **Relating the budget and the business plan:**

The business plan is the policy document that guides the budgeting process. A business plan is done for a period of years say five. A budget is only done on an annual basis to focus on activities for that year. Before you embark on the budget for a particular year, examine the business plan and select the objectives and targets set for that year and then budget accordingly. Ideally, the budget should target to attain or exceed the targets set in the business plan.

1. **Basis for estimationsof budgets:**

Construction budgets should be based on technical estimates such as those of quantity surveyors e.g. the BoQs, industry best practice, previous experience and market environment***.***

1. **Budget formats for materials, labour machinery:**

The following format may be used for compiling costs for labour, materials, and overheads***.***

|  |  |  |  |
| --- | --- | --- | --- |
| **Particulars**  | **Quantity**  | **Rate (Shs)** | **Amount (Shs)** |
| Materials | 5,000 tones | 20,000 | 100,000,000 |
| Labour | 2,000 man days | 30,000 | 60,000,000 |
| Machine hire | 100 days | 200,000 | 20,000,000 |
| Total direct costs |  |  | **180,000,000** |
|  |  |  |  |

1. **The standard budget:**

The budgeting process culminates in a total budget for the period or for a project. The total budget is not a good tool to use when works are ongoing as the actual output is different from total output. In order to control performance of the actual output we need to flex the budget to reflect the real situation.

Instead a cost per unit of output such as a kilometre is derived from the total budget and is used as a yard stick with which actual units of output can be flexed.

When units of output are actually known, the expected cost of actual production is ascertained using the standard cost. This is the flexed budget. Variances and control action are computed based on the flexed budget rather than the total budget. For example if we plan to do 24kms of road a year and we do 20kms only, control action is determined by flexing the budget to 20kms first using the budgeted cost of one standard kilometre of road.

1. **Group activity**
2. Develop a 3 months budget for 6kms of the 24kms contract of road that has been awarded to Munaku.
3. Develop a cash budget for the first 3 months of the contract.