

Budgeting

Are you going to be in control of your new business? Will you know in advance about any looming cashflow problems? Unless you use properly prepared budgets, the answer is likely to be no.

Budgeting sets out the financial targets for your business. It helps you anticipate problems and compare what has actually happened with what you expected.

This briefing explains:

- How to budget for your expected sales and costs.
- How to forecast your cashflow.
- How to compare your actual sales and costs to budget, and how to update your budgets.

1 Sales budget

The sales budget sets out how much you expect to sell (turnover) for each month of the next year.

Base your sales budget on the expected volume of sales of each product and the prices you intend to charge. If you are registering for VAT straight away, you should use prices excluding VAT in all your calculations.

1.1 If you have previous experience of this industry, what was the month-by-month pattern of sales figures in **past** years?

- Will the sales pattern be the same in your new business?

1.2 What sales are you **confident** of achieving?

- Do you have any firm orders? Will there be regular customers you can rely on?

1.3 Do you have the **capacity** to meet rising demand as your business grows?

1.4 What impact will your **marketing** have?

1.5 What effect will any **price changes** have on sales volumes?

1.6 What is your **competition** doing?

- Are you expecting to take customers from your competitors?

1.7 How is the **economic climate** changing?

- How will your core customers be affected?

1.8 Do you expect any **special circumstances** to have an effect on your sales?

1.9 What does the **complete** sales budget show?

- Do the monthly figures look realistic?

2 Expenditure budget

Once you have drawn up your sales budget, you can begin to work out your costs.

VAT-registered businesses should calculate costs excluding VAT.

2.1 What **fixed** costs will you have?

In other words, which costs must you pay, no matter how much you sell?

This would include:

- Rent, rates and insurance.
- Phones, Internet and computer costs.
- Interest charges.
- Maintenance and repairs.
- Electricity, gas and water rates.
- Staff wages and expenses.
- Advertising.
- Administration (eg accountants' fees).
- Depreciation of equipment, furniture and other fixed assets.

You will need to know what your fixed costs are, so that you can calculate what volume of sales you need to break even.

$$\text{£ breakeven} = \frac{\text{£ fixed costs}}{\% \text{ gross margin}} \times 100$$

In other words, if your gross margin is 25 per cent, sales must be four times as large as fixed costs, just to break even.

Playing the percentages

Percentages can be more revealing than figures in pounds and pence, especially if you sell a range of products.

- A** What percentage of **sales** do you expect for each product?
- You may want to concentrate your efforts on important products you think will represent a large proportion of your sales or highest profit margins.
 - Alternatively, products which make up a small percentage of your sales may provide an opportunity to sell more.
- B** How high will the percentage **profit margins** be on different products?
- Which products will provide the best profit margins?
 - How will your prices compare with competitors' prices?
 - Will the profit margin on each product be high enough to cover its share of the overheads?
- C** What percentage of your expected turnover will your **overhead costs** represent?
- For example, what percentages will be taken up by labour, premises and administration? Could you cut costs in any of these areas?

2.2 What **variable** costs will you have?

Which costs will grow or diminish in line with sales?

These could include:

- Raw materials.
- Distribution.
- Advertising.
- Extra staff costs, for overtime or temps.

2.3 Are any of these fixed or variable costs likely to **change**?

The expenditure budget will be far more useful if you separate out fixed and variable costs.

3 Cash budget

The cash budget (or cashflow forecast) uses the information in the sales and expenditure budgets to forecast the money going into and out of your bank account each month.

3.1 What is the **timing** of cash movements?

- When will the money from your forecast sales actually arrive?
Should you allow for a percentage of bad debts (sales which are never paid for)?
- When will you pay out for costs such as salaries, equipment and raw materials?
- Some payments will have to be made in advance (eg rent, rates and insurance) or by monthly standing orders.

3.2 What **other money** will you be receiving and paying out?

- Finance, eg receiving grant payments or repaying a loan.
- Any capital expenditure.
- Tax payments or rebates.
- VAT payments or receipts (if you are registered for VAT).

3.3 Using these figures, forecast your **bank balance** at the end of each month.

4 Balance sheet projections

While you are working on budgets, calculate the effect of meeting them on your assets and liabilities.

4.1 This will provide you with an **internal check** on their consistency.

4.2 It will provide you with **management information**.

“Using appropriate accounting software allows firms to more easily adjust their budgets to calculate the effects of any change in circumstances.”
Clive Lewis,
Institute of Chartered Accountants in England & Wales

- For example, it will show how much you are likely to be owed by customers at the end of the period, or how much you are likely to owe suppliers and HM Revenue & Customs for VAT and PAYE/NIC.

4.3 It will provide **financial information** for prospective backers.

- For example, your bankers will need information on your prospective balance sheet before they decide to lend to you.

4.4 It will focus your mind on the need for **capital spending**.

- It will show the impact of depreciation on the balance sheet value of new cars,

equipment and other fixed assets.

5 Preventive measures

Drawing up a budget enables you to spot problems before they happen.

5.1 Are you in danger of **underperforming**?

- Does your business need to build up sales as rapidly as possible?
- Will your forecast costs be too high? Where is there scope for cutting back?

5.2 Does your cash budget show that you are going to exceed your **overdraft limit** in any month? How will you improve cashflow?

- Collect sales income faster.
- Delay payments to your suppliers. Would this lose you discounts or damage your relationships with them?
- Arrange extra finance.
- Delay new capital expenditure.

5.3 Are you **over-trading**?

- The higher your sales, the more money you will need to spend on supplies and other costs — before paying yourself.
- If the level of sales becomes too high, your business may simply run out of cash.
- There is no point in capturing huge orders, if you run out of cash and go bankrupt.

6 Actual sales

Your budget is only an educated guess about the future. But once you have started trading, comparing your actual monthly sales and costs with the budget will let you know what is really happening. Begin with sales.

6.1 Was turnover **lower** than budget? Why?

- If prices or volumes were lower, why? Are prices or volumes likely to be lower than forecast in future months, too?

6.2 If turnover was **higher** than budget, why?

- Were sales brought forward from future months?
- Was the increase in sales caused by large one-off orders?

6.3 Were sales of any individual **product** lines significantly different from forecast levels?

- Is one product becoming outdated?

► The budgeting toolkit 'Making a Success of your Business' can be downloaded for free from the Chartered Institute of Management Accountants website: www.cimaglobal.com/Thought-leadership/Research-topics/Financial-reporting/Making-a-success-of-your-business1/.

“Don't be tempted to be over-optimistic in setting your budgets. You will only be fooling yourself in the longer term as the impacts on profit and then cash start to become obvious.”
Geoff Wightwick, Baker Tilly

Using budgeting software

Budgeting software makes it easier for you to produce and update the budgets and forecasts you will need to control your business' finances. It also makes budgeting errors less likely, and looks good to important outsiders such as banks.

Such software allows you to:

A Adjust your budgets **quickly**.

- To ensure your figures are up to date and realistic.
- To test what could happen if some of your forecasted figures are incorrect.

B Perform **automatic calculations**.

- To show how costs are changing in relation to each other (eg labour costs as a percentage of total fixed costs).
- To monitor the profitability of products.

C Use the automatic **links** between budgets.

- To see how changes in the sales or cost budgets will affect the cash budget. For example, would you run into a cashflow problem if sales were suddenly lower or higher than forecast?

D Produce fully **integrated forecasts** of your business' financial performance.

- Budgeting software can draw on budget figures to make the forecasts you need for your profit and loss account, balance sheet and cashflow statement.

- Is another product growing more popular?
- Do you need to focus your marketing or production plans on different products?

7 Actual costs

At the end of each month, check how your actual costs compare with the budget forecast.

7.1 Are they higher or lower **overall**?

7.2 Which **fixed costs** varied?

Was this a one-off, or will the fixed costs stay at these new levels?

For example, will you keep on extra staff?

7.3 How should **variable** costs have differed from budget?

- For example, consider a candle-maker with budgeted sales of 800 candles, using £800 of wax (eg £1 per candle).

If actual sales were 1,000 candles, the cost of wax should be £200 more than forecast.

7.4 How did **variable costs** differ from budget?

- If the candle-maker spent £1,100 on wax for 1,000 candles, the business has spent £100 more on wax than it should have. Looking at it another way, the cost of wax has risen by ten pence per candle to £1.10. Why? Did the price of wax increase, or was more wax wasted in production?

7.5 Are any of the cost changes **permanent** or do you expect costs to revert to normal?

8 Actual cash

8.1 How does your month-end cash balance **compare** with your forecast balance?

8.2 What caused any **differences**?

- Was turnover different from budget?
- Were costs different from budget?
- Was the timing of cashflow different?
For example, did customers delay payment longer than you had budgeted for?

8.3 Change your future cash budget to reflect any **timing** differences.

- For example, if sales were as expected, but a large customer delayed payment, you must increase the forecasted incoming cash for the month in which you now

expect to be paid.

8.4 Keep changing your future cash budget to reflect the **actual** cash balance.

- For example, suppose you have budgeted for an overdraft of £2,000 at the end of September, and £10,000 at the end of October. But at the end of September, the actual overdraft is £2,500. If nothing else has changed in the October budget, you should now budget for an overdraft of £10,500 at the end of October, £500 more than previously budgeted.

9 Keep up to date

9.1 Your budgets should always represent accurate and **realistic targets**.

- This way, you will know what to expect. You will be able to tell what has gone according to plan, and foresee problems and opportunities in time to take action.

9.2 If circumstances change, **update** your budgets — so that next month you can tell what else is different.

Expert contributors

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