

Budgeting

No business can know exactly what the future holds. But budgeting reduces the level of uncertainty, helping you anticipate problems, learn from the past and improve your ability to control the business.

This briefing will help with internal management decisions. People who own shares in the company or other equity providers may also require a budget or forecast to be provided regularly.

It outlines:

- How to forecast the figures you need.
- How to prepare cashflow, profit and loss, and balance sheet budgets.
- How to use your budgets.

1 Budgeting in the real world

Understanding common budgeting problems helps ensure your budgeting procedures work.

1.1 Involve the **right people** in the budget.

- Share relevant information between employees responsible for different functions (eg marketing or purchasing).
- Only give budget responsibility to those with authority to control the outcome.

1.2 Create **realistic** and up-to-date budgets using last year's figures as a guide.

- Allow at least two or three months to prepare for your annual budget and prepare 12-month forecasts on a rolling basis. Update your budget monthly and link it to your cashflow forecast using actual figures from the previous month (see **7** and **8**).

- Update all other budgets accordingly, using the original budget as a benchmark.
- To get the actual data you need, give spreadsheet templates containing relevant budget headings to individuals reporting budget information.

1.3 Use your budgets effectively. Using updated budgets lets you manage your cashflow and identify what needs to be achieved in the next budgeting period.

- Prepare consolidated budgets for the board to review monthly.
- Set up systems for early communication of likely budget variances (see **7** and **8**).

Directors' Briefing

a book in four pages

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If you need further information or help, ask the distributor of this briefing about the services available to you.

2 Forecasting sales

Sales forecasts are typically based on a combination of your sales history and how effective you expect your future sales to be.

2.1 Use your sales **history** as the basis for your forecasts, remembering that sales variations may reflect:

- How you market and price your product.
- Changes in your industry market, including what competitors are doing.
- Any other changes in your business, such as the launch of new products.

2.2 Assess what **sales resources** you have, and how you will use them. For example:

- What direct sales methods will you use? In each case, define how many potential customers you will contact and what success rate you expect.
- What advertising and other promotions will you carry out? How many enquiries do you expect as a result, and what percentage will turn into sales?
- How much of your sales effort will be directed at existing customers? What repeat business can you expect? Do

Costs checklist

A Costs that are largely **fixed** typically include:

- Rent, council tax and insurance.
- Financing costs.
- Maintenance and repairs.
- Utilities bills (eg electricity, gas and water rates).
- Salaries (including employer's National Insurance contributions and other PAYE payments).
- Planned advertising spend.
- Administrative costs (eg accountancy fees).
- Depreciation of fixed assets.

B Typical **variable** costs include:

- Raw materials.
- Distribution.
- Overtime payments and temporary employees.
- Wages directly linked to output levels.

C You may also incur **one-off** costs. For example, planned capital expenditure.

you have any confirmed orders already?

If this method of forecasting sales gives a very different picture from using historical performance, analyse why.

2.3 You may prefer to **build up** your sales forecast from separate forecasts for different products or geographical areas.

- Separate forecasts will help you to pinpoint problem areas, individual product profitability, and so on.

2.4 Take into account **seasonal patterns** in your business and industry.

- When do you plan to carry out particular promotional activities? For example, trade exhibitions.
- Are there any special events or circumstances this year? For example, a particularly late Easter, or major sporting events.

3 Forecasting costs

3.1 Analyse your costs and how they relate to sales (see box).

- Fixed costs are largely independent of the level of sales.
- Variable costs depend on turnover or number of sales. For example, distribution costs might be a percentage of turnover, a cost per sale, or a combination of the two.
- Semi-variable costs contain both fixed and variable components. For example, your power costs might include both a fixed component (for lighting and heating the office) and a variable component (for production).

3.2 Forecast your costs (either as a fixed amount or in relation to sales).

- Analyse historical records or contact suppliers for quotes.
- Take into account any expected price changes.

3.3 Control significant uncertain costs.

- Enter into long-term supply contracts or use forward foreign exchange contracts.
- Insure against possible disasters.

If you cannot or do not wish to fix costs, carry out sensitivity analyses (see **6**).

4 Preparing budgets

Use sales and expenditure forecasts to prepare your budgets. Get help if needed (see box).

4.1 Forecast the **timing** of cash movements.

- How quickly will you be paid for sales? What credit terms do you offer, and do customers pay on time? How much do you need to allow for bad debts?
- When will you pay out for costs? What will you pay in advance (eg annual insurance premiums)? Which supplies do you buy on account?

4.2 Include **non-operating** cashflow in your cashflow forecast. For example:

- Changes in financing (eg loan repayments).
- Tax and VAT payments and receipts.
- Dividends.

4.3 Prepare a **cash budget** (see 5.1).

Help where you need it

Many people can carry out basic budgeting procedures but may need help preparing balance sheet and profit and loss accounts, or conducting sensitivity analyses.

A Use the right **budgeting software**.

- Banks supply software free of charge.
- Sage's 'Winforecast' is the most user-friendly forecasting package (0800 44 77 77; www.sage.co.uk).
Get training from your local Business Link or relevant software manufacturer.
- Using browser interfaces can help reduce software licence fees and upgrade costs.

B Invest in basic accountancy **training**.

- This can be done part-time over a three-year period. Contact the Association of Accounting Technicians for details (0845 836 0800; www.aat.org.uk).

C Take **advice** from reputable accountants experienced in your industry. They can:

- Prepare updated balance sheets that are linked to your profit and loss and cashflow projections.
- Help you budget complex areas, such as directors' remuneration, and stock valuation.

4.4 Prepare **profit and loss** and **balance sheet** budgets.

- The profit and loss budget shows your projected profits for the period (eg the next 12 months).
- The balance sheet budget shows your projected balance sheet at the end of the period. It should include capital terms, such as new equipment, minus any capital disposals and should allow for depreciation of assets.
- Include as much detail as you will use in your budget analysis (see 5).

5 Budget analysis

Analysing your budgets gives you the chance to deal with potential problems before they occur.

5.1 Your **cash budget** projects your future cash position month by month.

- If your overdraft is projected to be close to or over your limit, you need to take appropriate action.
If you cannot, you may need to increase prices or ration sales to avoid the risk of bankruptcy through overtrading.
- If your cash position is extremely variable, you may need to analyse your cashflow into shorter time periods to see if a problem is likely at any point during a month.

5.2 **Profit and loss budgets** let you analyse projected margins and other key ratios.

- If margins are unsatisfactory, you may need to increase prices, reduce costs or focus on your most profitable lines.
- Growing businesses that are not yet profitable may find it useful to calculate the breakeven level of turnover.

5.3 Your projected **balance sheet** allows you to analyse stock turnover and other key figures.

- If working capital is growing faster than sales, you need to control it.
- Check how easily you can meet your financing payments.

5.4 **Compare** projected figures with previous years to see where performance is improving or deteriorating.

- You can also compare figures for projected margins and growth with those of other companies, or across different parts of your business.

5.5 Conduct **sensitivity analyses** to see how different outcomes affect performance.

As long as you prepare forecasts for the relevant information, you can budget for and analyse any of your key performance indicators.

6 Sensitivity analyses

6.1 Using forecasting software, it is easy to analyse the potential effects of **changes** to your budget assumptions.

- You can see the effects on your cashflow, profits and balance sheet.

6.2 As a minimum, carry out sensitivity analyses on different levels of **sales**.

- Typically, you might work with optimistic, pessimistic and most-likely scenarios.

6.3 Analyse the effects of any changes to significant **costs**.

6.4 Check the impact of any other significant **risks** to your business.

- For example, if 30 per cent of your turnover comes from one customer, what would happen if they stopped buying from you?

7 Actual income

Each month, compare your actual income with your sales budget.

7.1 Analyse the reasons for any **shortfalls** in turnover.

- Was the shortfall caused by lower sales volumes than expected, lower prices, or a different sales mix?
- Is the market less buoyant than expected or is your market share below target?
- Was a particular product responsible?
- Is a particular location underperforming?

7.2 If turnover was **higher** than budgeted, analyse the reasons.

- Were your budget targets too low?
- Was the increase in sales a one-off or the start of a trend?
- Have sales been brought forward from future months? Will sales in those months now be lower than originally forecast?

7.3 Compare the **timing** of income with your projections.

- Did sales campaigns take longer to have an effect than anticipated?
- Were customers slower to pay than you expected?

7.4 Analysing the differences will help you to improve your ability to set **future budgets** and allow action to be taken where needed.

- Do you need to change the assumptions on which you base your budgets?

8 Actual expenditure

Comparing your actual expenditure with budget also helps you to improve your ability to predict future costs accurately.

8.1 How did your **fixed** costs differ from your budget?

- Some fixed costs suddenly increase to a new level as the business grows.

8.2 Were your **variable** costs in line with your budget?

- Normally variable costs adjust in line with sales volumes achieved ('usage variance').
- Analyse the reasons for any change in the relationship between costs and turnover ('price variance'). Have unit costs changed (and are the new unit costs likely to continue in future)? Has the efficiency you use resources with changed?

8.3 Were there any differences in the **timing** of expenditure?

- Were any costs brought forward or delayed?
- Have suppliers' payment terms or your payment policies changed?

8.4 How did costs vary in different **parts** of the business?

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