Budgeting 101

We've all heard of budgets, both for business and home use, but many of us have only a vague sense of what a budget is and how it can help us. Though we'll discuss business budgets here, most of the concepts apply at home, too.

What is a budget?

Budgets are among the most basic planning tools for a business. They are part of the annual planning process and part of any business plan, whether for internal use, or for acquiring capital from a bank or investor.

A budget is the financial plan for a company's fiscal, or financial, year; it is a written plan describing where you will get your money, how you will spend it, and what you will do with what remains (or how you'll make up the shortfall). In a small business, the budget ensures that the business is viable and that you'll have enough money to run the business. In big business, the budget is a complex planning tool that sets priorities and allocates resources amongst competing demands, provides a benchmark for measuring performance, and helps to establish the forecasts that the stock market uses to value a business. A budget is generally built using spreadsheet software (e.g.: Microsoft Excel or Google Apps), though it can also be calculated by hand and presented on ledger sheets or as a table in a word processing document.

Why do I need a budget?

You may want a budget for a number of reasons.

"Best Practices" call for a business to generate an annual budget prior to the start of their fiscal year. This budget allows you to objectively consider the many tradeoffs you must make in running your business: Should I spend more on marketing or on R&D? If I raise my prices, will my unit sales fall more than my prices have risen? Would that new machine cut my production costs enough to pay for itself? Does it make sense to borrow money to advertise early in the year? It also helps answer many questions such as: How big a raise can I give my employees this year? Do I have enough money to buy that tractor? How much will I owe the bank at year end? If I slow my payments by five days, can I pay off my loan in June?

Your bank or investors may require a budget to ensure that their money is both well-managed and secure. Here the outside party will be looking to be sure that you meet certain ratios (debt service coverage, debt-equity, liquidity, or return on assets) or benchmarks (minimum profitability or cash flow). They may also want to know how much you expect to draw on your line of credit or when you expect to distribute cash to investors.

Another thing a good budget does is force you to understand the nuts and bolts of your business in an objective way that many managers never do. To build a budget that's more than a bunch of numbers typed into a spreadsheet, you have to identify, understand, and document the relationships and drivers underlying your business. The best budgets are constructed using lots of formulas that define things like how sales are calculated, how expenses vary with sales, and how depreciation relates to new capital purchases. You'll need to know: What are the recipes for your potions? How do you measure shrinkage? How seasonal is the business? What percentage of sales can be spent on advertising? What do the technicians really cost on an hourly basis?

Another trait of a good budget is that it is "self documenting". This implies that many or most of the assumptions being used in the calculations are explicitly described on an "Assumptions" page or elsewhere in the budget. Under the "Telephone" budget item, for instance, this might mean separate figures for local lines, long distance, and cell phones (possibly each cell phone listed separately). Under "Utilities", there might be separate figures for water, sewer, electricity, and heating oil, and heating oil might even note the assumed gallons used and price per gallon. The benefit of including this sort of detail is that you are documenting your operating plan as you build the budget itself. If utilities are over budget, look at the utilities section and see which utility is running high. If it's oil, is it because you're using more than you expected to or that rates have risen? Under budget on Trade Shows? Just look at the line items and see what you had planned to do but didn't, or which invoice hasn't come in yet. In any event, the greater the effort you put in building the budget, the easier it will be to troubleshoot later on.

Components of a Budget

You've now got a sense of what a budget can do for you and why you might want one. But what does a budget look like? What are its components? A proper budget is made up of three key outputs: an Income Statement or Statement of Profit and Loss, a Balance Sheet, and some form of Cash Flow Statement. Not coincidentally, these same three financial statements make up the core of a business's financial reporting package.

We're all familiar with the Income Statement, or Statement of Profit and Loss, which documents a business's revenues and expenses and totals to a Net Income for the period in question. The Income Statement strives to show how much money a company is making or losing by matching revenues with the expenses incurred to generate those revenues. Most people are also familiar with the Balance Sheet, which, rather than providing a summary of transactions over a period of time, provides a snapshot of what a business owns and owes at a specific point in time, generally matching the ending date of the accompanying Income Statement. The third component of a budget, the often overlooked Statement of Cash Flow, is both the most important and the least understood.

The Statement of Cash Flow comes in several different formats, but all provide the same basic information. A Statement of Cash Flow shows the sources and uses of a business's funds. It is generally made up of three sections, identifying flows related to the operating, investing, and financing activities of the business.

The Operations section starts with the business's Net Income and then makes adjustments for non-cash transactions included in the Income Statement (such as Depreciation and accruals) and for cash transactions related to daily operations that are not reflected in the Income Statement during the period (inventory purchases, changes in Accounts Payable or Receivable). The total of the Operations section is the Operating Cash Flow, which represents the Operating Income of the business after conversion from an accrual basis to a cash accounting basis. The Investing section of the Statement of Cash Flow shows cash used in "investing" activities, such as purchasing fixed assets like a new machine or a new truck. The final section, Financing, includes cash flows related to a company's financing activities, such as loan borrowings and repayments or the issuance of stock or equity in the business. This section will also capture related transactions, such as dividend payments, purchases of treasury stock, and owners' draws. Essentially, the Operations and Investing sections of the Cash Flow Statement show how the company is making its money and what it's doing with it, while the Financing section shows how they make up the shortfalls and what they do with what's left.

In the long run, what really matters to an investor is the amount of cash that is generated, or used, by a business. Businesses that generate lots of cash on an ongoing basis are more valuable than those that generate less cash, or demand ongoing cash infusions to continue operating. The need to understand how much cash is being generated and how is what makes the Statement of Cash Flow so important. Remember the old adage, "Cash is King"!

Methods of Budgeting

There are two basic methodologies used in constructing budgets – "Prior-Year-Based" and "Zero-Based". Most budgets are, in fact, blends of the two methods.

Prior-year-based budgets are prepared by taking last year's actual (or projected) results and adjusting them based upon anticipated changes in the new year. For instance, you might increase most expense lines by two percent to account for inflation. Then you can modify specific income or expense items differently for a variety of reasons – revenues grow by 15% with the addition of a new product line; office rent stays flat per your lease; wages increase by 3.5% in accordance with your union contract; utilities increase by 20% due to higher oil prices and telephone expense grows by $200 per month due to additional cell phone purchases.

While prior-year-based budgets are easier to construct, zero-based budgets are generally preferred because they can be more accurate and are better documented. A zero-based budget itemizes the actual items expected to be purchased and sold to arrive at a budget for each revenue and expense account. For instance, the revenue line will be calculated as representing sales of 400 of Widget A at $25.00, 250 of Widget B at $17.50, and 175 of Widget

C at $9.25; heating costs will be based upon 1500 gallons of oil at $3.25 per gallon; and copier expense will include a $480 maintenance contract plus 8 cases of paper at $32 per case.

While zero based budgets have many advantages, they are often too cumbersome to develop for every account. For instance, it's probably not worth estimating the number of pencils or pads of paper that you will use in a year. Therefore, budgets for accounts such as Office Supplies are rarely zero-based. The same holds true for other accounts that may be impossible to itemize because you can't predict the future. It's awfully hard to know what will break during the coming year, so Repairs budgets are rarely zero-based, but are likely to be calculated as "3% more than last year". Some individual account budgets are hybrids, such as a Telephone budget that may be made up of several known service charges and a monthly long distance component that is based upon last year's activity plus a small percentage increase. Company budgets are frequently made up of a blend of some account budgets that are prior-year-based, some that are zero-based, and some that are blends of the two methods.

Conclusion

In the end, a budget serves several purposes and several masters. In today's challenging financial environment, a basic budget is a necessity, both for internal planning, managing, and measuring, and for negotiating and communicating with your financial partners, whether equity holders or banks. A good budget enables you to better manage your business, intelligently balancing tradeoffs, analyzing changes, and promoting accountability within the organization. Above all, however, the information gleaned from a budget should be actionable, providing the financial plan for the year and the basis for decision making – both in the planning stages and as the year unfolds. A well thought out budget should be the primary annual planning tool for any business, large or small.

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