Guide from

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Budgeting

Budgeting sets out your financial expectations for the business. While it's not possible to know exactly what the future holds, budgeting reduces the level of uncertainty and helps you anticipate problems.

Actively using your budgets, and comparing them to the actual outcome, also lets you learn from the past and improve your ability to control the business.

1. Budgeting in the real world

Understanding common budgeting problems helps ensure your budgeting procedures work.

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.

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 cash flow forecast using actual figures from the previous month.
- 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.

Use your budgets effectively

- Using updated budgets lets you manage your cash flow 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 variances in actual income and actual expenditure.

Improved budget management allows you to react quickly to potential problems

- Produce budget reports as soon as possible after the period ends.
- Take prompt action arising from the board review of budget reports.
- Use key performance indicators based on budget forecast reports for more frequent progress updates (real time, hourly or daily figures).

2. Forecasting sales

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

Use your sales history as the basis for your forecasts

Take into account how sales may vary in response to:

- how you market your product;
- the effect of any price changes on sales volumes;
- the economic climate and its effect on your customers;
- changes in your market, including what competitors are doing;
- any other changes in your business, such as the launch of new products.

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 you have any confirmed orders already?

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

You may prefer to make separate forecasts for different products or regions

- You can build up an overall sales forecast from these forecasts.
- Separate forecasts will help you to pinpoint problem areas, individual product profitability, and so on.

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.

Check that your forecasts are realistic

- What sales are you confident of achieving? Do you have firm orders or customers you can rely on?
- How quickly do you expect to attract new customers? It is easy to be over-optimistic, particularly when you are starting a new business or moving into a new market.
- Have your industry's sales in recent months been higher or lower than a year ago? How does your sales forecast compare?
- Are you expecting to take customers from your competitors? How will they respond?
- Do you have the capacity to cope with any sales growth you are forecasting?

3. Forecasting costs

Analyse your costs and how they relate to sales

- 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) and a variable component (for production).

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.

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, check the possible impact in your budget analysis.

Costs checklist

Fixed costs

Costs that are largely fixed typically include:

- rent, council tax and insurance;
- financing costs;
- maintenance and repairs;
- utilities (eg electricity, gas and water rates);
- salaries (including employer's National Insurance contributions and other PAYE payments);
- planned advertising;
- administrative costs (eg accountancy fees);
- depreciation of fixed assets.

Variable costs

These typically include:

- raw materials;
- distribution;
- overtime payments and temporary employees;
- wages directly linked to output levels.

One-off costs

- For example, planned capital expenditure.

4. Preparing budgets

Use sales and expenditure forecasts to prepare your budgets. Get help where you need it.

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?

Include non-operating cash flow in your cash flow forecast

For example:

- changes in financing (eg loan repayments);
- tax and VAT payments and receipts;
- dividends.

Prepare your budgets

- The cash budget (or cash flow forecast) shows your monthly cash flow and bank balance.
- 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 items, 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.

5. Budget analysis

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

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: for example, arranging additional financing.
- If your cash position is extremely variable, you may need to analyse your cash flow into shorter time periods to see if a problem is likely at any point during a month.

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

- Which products and markets provide the largest share of sales? Which are growing fastest?
- How do margins compare for different products and different markets? 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.

Your projected balance sheet helps you analyse key figures

- These include stock turnover, how long it takes to collect customer payments and how quickly you pay suppliers. If working capital is growing faster than sales, you need to control it.
- If you cannot control your working capital requirements, you may need to increase prices or ration sales to avoid the risk of bankruptcy through overtrading.
- Check how easily you can meet your financing payments.

Compare projected figures with previous years

- Identify 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.

Assess how different outcomes affect performance

- As a minimum, carry out sensitivity analyses on different levels of sales. Typically you might worth with optimistic, pessimistic and most-likely scenarios.
- Analyse the effects of any changes to significant costs.

- 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?

- Using forecasting software makes this analysis easy. You can see the effects on your cash flow, profits and balance sheet.
- As long as you prepare forecasts for the relevant information, you can budget for and carry out sensitivity analyses for any of your key performance indicators.

6. Actual income

Each month, compare your actual income with your budget.

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?

If turnover was higher than budgeted, analyse the reasons

- Were your 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?

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?

If necessary, change future budgets

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

7. Actual expenditure

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

How did your fixed costs differ from your budget?

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

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?

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?

What is the overall effect on your cash position?

- How does your month-end cash balance compare with the forecast?
- What changes do you need to make to your future budget?

8. Help where you need it

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

Use the right budgeting software

- Some banks supply software free of charge.
- Get training from your local business support organisation or relevant software manufacturer.
- Using online budgeting services can help reduce software licence fees and upgrade costs.

Take advice from your accountant

They can:

- prepare updated balance sheets that are linked to your profit-and-loss and cash flow projections;
- help you budget complex areas, such as directors' remuneration and stock valuation.

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