

Basic Budgeting for the Small Business



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The concept of Budgeting is important for all businesses no matter what their size is, but is vital for a small business.

Many small businesses overlook budgeting because it just seems like more paperwork which is diverting the business owners time away from other key tasks. Whereas, budgeting can help eliminate the pressure of time as it prepares for the future and foresees the problems before they occur.

Hopefully, after reading this article, you will learn that budgeting is an integral process in business and realise that the way forward comes from successful planning. It will cover the basis concepts of budgeting and take you through the step-by-step process of preparing a budget.

What is a Budget?

A budget is a plan of all income and expenditures expected over a select period. It is organised in the same format as an operating statement, and most commonly covers a twelve month period. At the end of the year, the anticipated income and expenses developed in the budget are compared to the actual performance of the business.

A budget is not a forecast: a forecast is a prediction of the future whereas a budget is a planned outcome of the future that the business wants to achieve.



Why create a Budget?

A budget can enhance your chances of success by helping you estimate future needs and plan profits, spending and overall cash flow. A budget allows you to perceive problems before they occur and alter your plans to prevent those problems.

Basic Budgeting Concepts

The three main elements of a budget are:

- Sales revenue
- Total Costs
- Profit

Sales Revenue

Sales are the cornerstone of a budget. It is essential to estimate expected sales as accurately as possible. You should base estimates on actual past sales figures. Once you target sales, you can calculate the related expenses necessary to achieve your goals.

Total Costs

Total costs include fixed and variable costs. Estimating costs is not easy because you must identify which costs will change and by how much and which costs will remain unchanged. You also must consider inflation and rising prices when applicable (eg. rises in petrol prices may have a significant impact on your business your costs).

Variable costs

Variable costs are those that vary directly with sales. One example is the purchase cost of inventory. The more inventory you sell, the higher your purchasing costs and vice versa. Similarly, freight and packaging costs will vary directly with sales as these costs are generally not incurred unless a sale occurs.

Fixed Costs

Fixed Costs are those that do not change, regardless of sale volume. Rent is considered a fixed cost because it is totally independent of sales activity and, for the duration of the lease, will not change.

Semi-variable costs

Semi-variable costs, such as salaries, wages and telephone expenses, have both variable and fixed components. For budgeting purposes, we may need to break semi-variable costs into these two components. The fixed element represents the minimum cost of supplying a good or service. The variable element is that portion of the cost influenced by changes in activity. For example, a photocopying machine will have a fixed cost per month plus a variable cost based on the volume of usage.

Profit

Profit should be large enough to make a return on cash investment and a return on your work. Your investment is money you put into the business when you started it and the profit of prior years that you have left in the business (retained earnings). This means that if you can receive ten percent interest on \$25,000 by investing outside of your business, then you should expect a similar return when investing \$25,000 in equipment and other assets within the business.

In targeting profits, you want to be sure you are receiving a fair return on your labour. Your weekly wage should reflect what you could be earning elsewhere as an employee.

If your budget doesn't reflect a return on your investment or labour then your business isn't working for you, you are working for it.

What if my business is new?

If your business is new and has no past financial records, you should rely on your own experience and knowledge of the industry to estimate demand for and costs of your product or service. You may need to enlist the



assistance of a professional accountant or business consultant. You can also contact your industry associations for benchmarks to help you.

Always remember that for your budget to be helpful, the estimates you use must be realistic.

The Budgeting Process

Before you can create a budget, you must answer three questions:

1. How much net profit do you want the business to generate during the financial year?
2. How much will it cost to produce that profit?
3. How much sales revenue is necessary to support both profit and costs?

To answer the above questions, consider expected sales and all costs, direct or indirect, associated with the product or service. To make the safest estimates when budgeting, most businesses prefer to overestimate expenses and underestimate sales revenue.

	Amount (\$)	% of sales
Sales	490,667	100%
Cost of goods sold	343,467	70%
Gross profit margin	147,200	30%
Operating expenses		
Variable Costs		
Advertising	3,500	1%
Accounting and legal	2,500	1%
Office expenses	3,000	1%
Repairs and maintenance	1,000	0.2%
Telephone and utility costs	7,500	2%
Miscellaneous	5,000	1%
Fixed Costs		
Rent	24,000	5%
Insurance	1,700	0.3%
Salaries	33,000	7%
Total operating expenses	82,200	17%
Net Profit	65,000	13%

Preparing a Budget

For practical purposes, most small businesses start with the amount of planned profits and work backwards. In other words, decide what profit you want to make and then list the expenses you will incur to make that profit.

A budget can be produced as a five step process:

1. Target desired profit
2. Determine operating expenses
3. Calculate gross profit margin
4. Estimate sales revenues
5. Revise and adjust the figures

In order to demonstrate this five step process a sample budget for ABC Beauty Products has been prepared. Why don't you follow the steps yourself as a learning exercise?

Once you have calculated projected sales, expenses and profit, organise the figures into the format of an operating statement as illustrated and compare it to the one prepared at the end of this article.

Step 1: Target desired profit

Let's assume that the required profit is \$65,000 per year based on earnings that could be generated by the business owner as an employee plus an additional 10% for risk taken as a business owner. This is becomes our starting point.

Step 2: Determine operating expenses

Based on prior year analysis, ABC Beauty Products estimates it will have the following fixed and variable costs:

Under fixed costs, the business estimates that:

- Rent will be \$24,000 per year
- Salaries will be \$33,000 per year
- Annual insurance will be \$1,700 per year

The businesses variable costs are estimated to be:

- Telephone and utility expenses are \$7,500
- Advertising will be \$3,500
- Repairs and maintenance will be \$1,000
- Office supplies will be \$3,000
- Accounting and legal fees will be \$2,500
- Other miscellaneous expenses will be \$5,000

Use these amounts to calculate gross profit under step 3.

Step 3: Calculate gross profit margin

Gross profit margin is the sum of net profit and operating expenses, calculated by working the budget in reverse.

ABC's gross profit margin is obtained by adding net profit of \$65,000 to operating expenses of \$82,200, equalling \$147,200.

Step 4: Estimate Sales revenue

To target sales, the gross profit margin should be analysed. You should review your actual gross profit margins of prior years or look at industry benchmarks to consider what margins you have or should be achieving.

For this example, it has been assumed that a thirty percent gross profit margin has been achieved by ABC over the past three years and should continue. Since a gross profit margin of \$147,200 is expected to equal thirty percent of net sales, then targeted net sales should equal \$490,667 ($\$147,200 / 0.30$).

Step 5: Revise and Adjust figures.

If the initial figure for targeted net sales seems realistic, the budget is complete. If generating the amount of targeted net sales will be a problem, the budget must be revised and adjusted accordingly.

You may need to consider reducing some of your expenditure, like your employment costs and cheaper telephone arrangements or putting off expenditure on repairs until a later time.

Once you have finalised your budget, don't just tuck it away. It is an ongoing business tool.

Budgeting as an Ongoing Process

The budget may have to be altered during the year to reflect changing circumstances. There may be a sharp rise or drop in one or more variable expenses or in revenues. Often, budgets are divided into smaller monthly or quarterly budgets. Monthly budgets are used to measure actual results against budgeted goals.

Remember, you've put in the effort and created a budget, so follow it! If you don't you'll lose the benefits that you planned for when you built it. You should also be prepared to miss your budget estimates and act accordingly. Be flexible in your approach to using this tool. A good budget is great, but don't let it dictate your business.

Summary

A budget is an indispensable tool for turning your business plans into reality. The budget helps focus your thoughts on the direction in which you are headed. It indicates how much cash you have to spend, your expenses and how much you need to earn. By planning on paper first, you minimise the risks associated with your business endeavour. A good budget can build morale by helping you organise, communicate and motivate employees to do their part in achieving the business's financial goals. **B**

For more information on the budgeting process or assistance with creating a budget for your business, please contact Michelle Pearce from FACE Chartered Accountants on (02) 9555 1309. FACE Chartered Accountants is an advisory firm located in Balmain NSW.

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