Setting Budgets

Introduction

When you hear the words budgets and financial planning you probably feel the urge to fall asleep. However, if you can stay awake whilst you work through this section of BUSS1, it will be worth it. For setting budgets is an important part of starting a new business and it is closely linked to the topics of:

- Cash flow forecasting, and
- Business plans

So what is a budget? A good definition of a budget is a financial plan for the future concerning the revenues and costs of a business.

A financial plan for the future might sound a bit like the cash flow forecast and you would be almost right! However, there are two key differences between a budget and cash flow forecast.

The first is that a budget is focused on the **trading profitability** of the business rather than the cash flows. When looking at budgets, you are really concerned with sales (revenues) and costs. In other words, a budget is an estimate of sales income together with the costs required to produce those sales.

The other key difference is that a budget is a plan it outlines what the business **wants to happen.** This is different from a forecast, which is what a business expects to happen.

Budgets are all about **setting targets** and **allocating resources**. In order for a budget process to be effective, a business needs to:

- Estimate sales reasonably accurately (sales budget), and
- Estimate costs precisely (expenditure budget)

Another important point to remember is that budgeting is part of **financial control.**

Financial control is different from **book-keeping** (which is about recording the financial transactions of a business). Book-keeping is, of course, important since any business needs accurate and up-to-date figures about its financial position. However, financial control is about using the figures to keep control over the business.

As we shall see, the use of budgets brings some important disciplines to the management of any business large or small.

Why businesses use budgets

Here are the main reasons why businesses set up and use budgets:

Budgets are used to measure whether key business objectives and targets are being achieved. For example, if the budget has an objective of achieving sales of 150,000 in the first year of trading, then the actual sales can be compared with this budget to measure success.

Budgets play a key role in controlling expenditure. The budget sets out the costs that the business can afford to incur. When actual costs are measured, the entrepreneur can see whether the expected costs are likely to more or less than expected.

Budgets can provide a sense of direction for management and employees in the sense that they include targets that provide a focus. However, remember that most start-ups businesses will have few, if any, employees. So the direction-setting purpose of the budget is really for the entrepreneur.

For a small business or start-up, the process of creating a budget is relatively straightforward, although that doesn t mean it is easy.

Sales budget

The hard bit for a new business is to work out the projected sales for the budget period. The sales budget needs to take into account factors such as the size of the market, existing competitors and their response and the capacity of the business.

? What sales volumes will be achieved?

? What price can the product or service be sold at?

? When will the sales arise and through which distribution channels?

For the sales budget, it is important to be realistic. An overly-optimistic sales budget will probably give the impression that the business will generate more cash than it actually can.

Market research places a key role in the sales budget of a start-up. The assumptions made in the sales budget about selling prices, volumes and distribution channels (where products will be sold) need to be realistic and informed by what the business can find out about what really happens in the market.

Ideally, the sales budget will be based around assumptions made for individual products or product groups. The budget for each product is then added up to make the overall sales budget. A simple example is illustrated below:

Sales Budget **Niche Children's Fashions Ltd**

Product	***Qty***	***Price***	***Sales***

	000	□ */ unit*	□ *'000*
Girls Jackets	3.0	□11.99	□36.0
Boys Jackets	4.5	□12.99	□58.5
Girls Blouses	2.5	□8.99	□22.5
Boys Shirts	5.0	□7.99	□40.0
Total	15.0		□156.9

Expenditure budget

The next step is to assess what the costs are of delivering the sales budget. This is the expenditure (or costs) budget and is concerned with question such as:

? What are the direct **costs of sales** □ i.e. costs of raw materials, components or subcontractors to make the product or supply the service?

? What are the sales-related expenses, such as commissions?

? What are the fixed costs or overheads?

It is important that the expenditure budget is broken down into as much relevant detail as follows.□ For example, the budgeted fixed costs and overheads could be analysed by type, such as:

? Cost of premises, including rent, rates, office insurance etc

? Staff costs □ wages and salaries (don□t forget to allow for employer□s national insurance)

? Utilities □ e.g. lighting, heating,

? Communication costs □e.g. main telephone, mobile phones, internet and email access, web hosting

? Marketing and other printing, postage and stationery

? Vehicle expenses

? Equipment costs (including relevant software licences)

? Advertising and promotion

? Travel and subsistence expenses

? Legal and professional costs, including the costs of setting up the business structure

You can see from the list above that there are many items of expenditure that need to be considered by the start-up prior to trading. Most of the above cost categories will continue to be incurred by the business once it has started trading.□ However, the expenditure budget is particularly important for a start-up since it does not begin to generate income until its starts to trade with customers.□ Costs, on the other hand, are often incurred well before the first customer is served!

Market research also comes into play when creating the expenditure budget. It is particularly important if the entrepreneur has no previous experience of operating in the target market.

The overall aim of the expenditure budget is to ensure that it is **prudent** and **complete**. What do we mean by these two terms?

Prudent the budget makes sensible, cautious assumptions about the value of costs to be incurred. For example, a prudent expenditure budget does not assume that the business will operate at maximum efficiency or that raw materials will be sourced at the best possible price. To do so would be to create unrealistic expectations about what the profitability of the business can be.

Complete the expenditure budget does not miss out any significant items or categories of cost. For example, if the start-up plans to sell via e-commerce, the expenditure budget should include items such as web design, server hosting, transaction fees etc. There is nothing worse when a start-up begins trading to discover a bunch of costs that had simply been missed when the expenditure budget was put together!

Profit budget

The profit budget is simply the difference between the sales budget and the expenditure budget.

The profit budget shows what the budgeted net profit is for each of the budgeted periods (usually months).

In other words, having got budgeted figures for sales and expenditure, the start-up can work out how much profit it should earn as it begins life as a new business.

The profit budget isn't simply a mathematical calculation (performed by a spreadsheet). It enables the entrepreneur to look at costs and work out ways to reduce them. It can also help highlight potential cash flow problems, since periods where the business is budgeted to be loss-making are often associated with negative cash flow.

Methods of setting the budgets

In most established businesses, the budget-setting process is quite straightforward. Managers look at what actually happened last year, what has changed in the business and its markets, and then set a new budget that reflects the targets and objectives they want to achieve. In reality, this can be quite time-consuming (especially for a multi-location & complex business), but at least the budget-setters have the advantage of using real information on how the business trades.

However, remember that in BUSS1 we are mainly looking at a **new business** that is getting ready to trade. Management don't have the luxury of lots of historical sales and expenditure data. Time is short too there are lots of other activities that need to be done rather than spending lots of effort on putting a budget together.

So, for the start-up entrepreneur, setting a sensible budget is a tough job. How does he or she do it? Here are some tips:

An entrepreneur with some experience of the market will make good use of rules of thumb to set key assumptions in the budget. For example, he/she may know that the average mark-up on cost is 60%, or that the average selling price is three times raw material costs. Using these guides, if accurate, helps make sensible assumptions. Rules of thumb are identified in several ways. One great method is to simply speak to suppliers!

Market research should be used wherever possible to fill in the gaps. We touched on this when describing how the sales budget can be prepared.

Good use of advisers and consultants helps too. For example, the main high street banks have detailed experience of most markets and industry sectors; they provide free guides to the main business planning issues in these markets. Good use of expert information, usually available for free, can help make the budgets realistic and reduce the time taken to complete them.

An experienced entrepreneur will accept that some elements of any start-up budget will simply be based on guesstimates or hunches. This is often the case for the sales budget. As long as the budget is revisited frequently and costs have been prudently estimated, then the use of guesstimates is fine.

Time spent working on the budget, and then periodically reviewing and amending the main assumptions, is time well spent. The budget-setting process need not take forever (a well designed spreadsheet can save dozens of hours).

Limitations of budgets

Whilst the budget-setting process is a useful management discipline, you need to be aware of the many limitations of budgets, particularly for start-ups and small businesses:

- Budgets are based on **estimates and assumptions**. By definition, actual results will vary from the budget (these are known as variances and you will cover these in BUSS2). The important point is that a business needs to know **why** actual results vary from budget.
- A start-up has no trading history which it can use to base the budget assumptions. For example, it would be nice to know about the seasonal profile of demand and to see what costs are actually incurred by the business idea. The first time the start-up budget is prepared, much of this information has to be guesswork (a similar problem exists when it comes to preparing the cash flow forecast).
- Setting and monitoring budgets takes time. We know that most start-up entrepreneurs are short of time. So a start-up budget (if it is produced at all) is often kept quite simple and brief so that the entrepreneur can focus efforts on other tasks.
- The motivational effect of setting budgets is limited if the start-up has no or few employees and managers.

Exam tips

Remember that, for the start-up entrepreneur, the time spent setting and monitoring budgets has an opportunity cost. Three days working on a budget spreadsheet could be spent instead on visiting customers, training staff or developing new product ideas. As a result, an effective budget system for a start-up is likely to be pretty simple - often nothing more than a single spreadsheet. Don't be too critical of a BUSS1 case study business that finds it hard to summon enthusiasm for a complex budgeting process!

Guided revision questions

Revision questions for Setting Budgets

(1) Define what is meant by the term "budget" (2 marks)

(2) List three advantages that a budgeting system brings to a business (3 marks)

(3) Why might a budgeting system help a start-up business to control expenses? (2 marks)

(4) List three different kinds of budget that might be created by a start-up business (4 marks)

(5) Identify five areas that a business should research so that it can produce realistic budgets (6 marks)

(6) What items might be included in the materials budget for a start-up manufacturer of processed foods? (3 marks)

(7) Explain why it is important for a start-up business to estimate with reasonable accuracy the level of future sales (4 marks)

(8) Why do small businesses traditionally find it harder to budget realistically for revenues? (2 marks)

(9) List three reasons why a new fast-food outlet may be unable to budget its sales accurately during the first year of trading (3 marks)

(10) Explain why costs are generally related to the level of a business's activity (4 marks)

(11) Explain the link between a business budget and the aims and objectives of a start-up business (4 marks)

(12) How often might a start-up business monitor actual results compared with a business? (4 marks)

(13) Explain three reasons why a start-up business might find the budgeting process difficult (6 marks)

(14) How might budgets motivate staff? (4 marks)

(15) Explain why a small business might benefit from setting budgets on areas such as advertising, travel and accommodation costs (4 marks)