Business Success STRATEGIES

COST AND BUDGETS

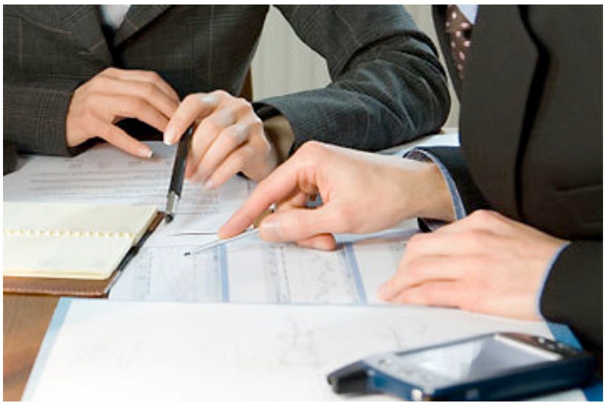
Budgeting is a basic and essential process that allows your business to attain many goals in one course of action. Planning is the primary purpose of budgeting, as budgets allow a business to take stock of revenue and expenses from a previous period, and gauge where the business will be in a future period.

Budgeting is about maintaining control and evaluation in and over your business. Having a degree of control over costs, such as not allowing many types of expenses to take place if they were not budgeted for, is important to ensure cash flow and growth.

At times budgeting can generate negative feelings with employees because their compensation and, indeed, their jobs, may be dependent on meeting certain budgeting goals. This happens when budgeting is used for evaluation or is a top-down process, rather than a participative one.

Involving your team and people in the budget is the best way to turn a budget into a motivation and communicate financial objectives so that resources can be coordinated and focused in key areas with less resistance. Importantly when an employee is involved in creating his or her department's budget, that person will be more likely to strive to achieve that budget.

Business budgeting is important to overall business strategic planning. Whether it's personal or business budgeting taking the time to quantify income and to track expenses is a key part of business planning.



Financial planning tools are available to facilitate tracking and planning.

Whatever financial tool is used - budgeting tool, financial planning software or the more traditional way of hiring a financial adviser - basic factors to achieve an effective budget remain the same.

In preparing a budget, there are two basic elements in any simple or complex budget planning: income and expenses. A person who has a full-time job is certainly different from a self-employed business owner. It may be more than a struggle for the self-employed to wait for that contractual payment to come in rather than an employee who is sure to receive a weekly, fortnightly or a monthly pay. Both will have a different effect on budgeting. But in all cases the total income must be identified and recorded, and all expenses receipts whether weekly, monthly, quarterly and annual must be identified and recorded.

Financial goals may be short-term and/or long-term. Personal or family financial goals must be identified. Singles don't have to worry about family finances. Their financial goal may be to pay off a mortgage in 10 years, reduce a credit card or repay a personal loan, start a business, or a plan a holiday. For those with families, goals include college education for children. But whatever they are, financial goals must include planned purchases and expenditures.

Financial goals need to be reviewed on a regular basis to gear up proper handling of finances, because accurate budgeting and a tight control of costs are vital to the profitability of any business. New small business owners may run their businesses in a relaxed way and may not see the need to budget. However, if you are planning for your business' future, you will need to fund your plans. Budgeting is the most effective way to control cash flow, allowing you to invest in new opportunities at the appropriate time.

Business requires different budgets at different times of growth. For example:

1. Start-up costs are financed by start-up capital. These include buying a first stock of materials, though it is important to keep inventory low when starting, and the essential communication equipment of computers and phones, etc.

2. Running and renewal costs are financed by working capital: producing goods or services, e.g. wages, insurance, electricity, materials, rent for premises and machinery.

3. Expansion costs are financed by investment: installing more production lines, employing new staff, opening new premises, developing a new product, etc.

As your business grows, you will have to split your budget up between different areas such as sales, production, marketing, etc.

As money starts to move in many different directions through your business - budgets are the vital tools to ensure that you stay in control of expenditure.

Developing your budget is your plan to:

- Control your finances.
- Ensure you can continue to fund your current commitments.
- Enable you to make confident financial decisions and meet your objectives.
- Ensure you have enough money for your future projects.

A budget outlines and/or details what you will spend your money on and how that spending will be financed. However, it is not a forecast. A forecast is a prediction of the future whereas a budget is a planned outcome that your business wants to achieve.

A business budget allows you to:

- **Manage your money effectively.**
- **Allocate appropriate resources to projects.**
- **Monitor performance.**
- **Meet your objectives.**
- **Improve decision-making.**
- **Identify problems before they occur - such as raising finance or cash flow difficulties.**
- **Plan for the future.**
- **Increase motivation.**

Creating, monitoring and managing a budget is the key to your business success. It should help you allocate resources where they are needed, and should not be complicated. You simply need to work out what you are likely to earn and spend in the budget period.

Begin by asking these questions:

- What are the projected sales for the budget period? Be realistic - if you overestimate, it will cause you problems in the future.

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

- What are the fixed costs or overheads?*

*You should break down the fixed costs and overheads by type, e.g:

- **Cost of premises, including rent or mortgage, business rates and service charges.**
- **Staff costs – e.g. pay, benefits, National Insurance.**
- **Utilities – e.g. heating, lighting, telephone or internet connection.**
- **Printing, postage and stationery.**
- **Vehicle expenses.**
- **Equipment costs.**
- **Advertising and promotion.**
- **Travel and subsistence expenses.**
- **Legal and professional costs, including insurance.**

Your business may have different types of expenses, and you may need to divide the budget by department. Don't forget to add in how much you need to pay yourself, and include an allowance for tax.

Your business plan should help in establishing projected sales, cost of sales, fixed costs and overheads, so it would be worthwhile preparing this first.

Once you have figures for income and expenditure, you can work out how much money you're making. You can look at your costs and work out ways to reduce them, as well as seeing if you are likely to have cash flow problems, and giving yourself time to do something about them.

You should stick to your budget as far as possible, but review and revise it as needed. Successful businesses often have a rolling budget.

There are a number of key steps you should follow to make sure your budgets and plans are as realistic and useful as possible:

Make time for budgeting. If you invest some time in creating a comprehensive and realistic budget, it will be easier to manage and ultimately more effective.

Use last year's figures - but only as a guide. Collect historical information on sales and costs if they are available - these could give you a good indication of likely future sales and costs.

It's also essential to consider what your sales plans are, how your sales resources will be used and any changes in the competitive environment.

Create realistic budgets. Use historical information, your business plan and any changes in operations or priorities to budget for overheads and other fixed costs.

It's useful to work out the relationship between variable costs and sales and then use your sales forecast to project variable costs. For example, if your unit costs reduce by 10% for each additional 20% of sales, how much will your unit costs decrease if you have a 33% rise in sales?

Make sure your budgets contain enough information for you to easily monitor the key drivers of your business such as sales, costs and working capital.

You should first decide how many budgets you really need. Many small businesses have one overall operating budget that sets out how much money is needed to run the business over the coming period - usually a year. As your business grows, your total operating budget is likely to be made up of several individual budgets such as your marketing or sales budgets.

What your budget will need to include:

Projected cash flow - your cash budget projects your future cash position on a month-by-month basis. Budgeting in this way is vital for small businesses as it can pinpoint any difficulties you might be having. It should be reviewed at least monthly.

Your business will have three kinds of costs:

- **Fixed costs** - items such as rent, rates, salaries and financing costs.
- **Variable costs** - including raw materials and overtime.
- **One-off capital costs** - for example, purchases of computer equipment or premises.

Revenues - sales or revenue forecasts are typically based on a combination of your sales history and how effective you expect your future efforts to be.

Using your sales and expenditure forecasts, you can prepare projected profits for the next 12 months. This will enable you to analyse your margins and other key ratios such as your return on investment.

Use your budget to measure performance.

If you base your budget on your business plan, you will be creating a financial action plan. This can serve several useful functions, particularly if you review your budgets regularly as part of your annual planning cycle.

Your budget can serve as:

- An indicator of the costs and revenues linked to each of your activities.
- A way of providing information and supporting management decisions throughout the year.
- A means of monitoring and controlling your business, particularly if you analyse the differences between your actual and budgeted income.

Benchmarking performance:

Comparing your budget year on year can be an excellent way of benchmarking your business' performance - for example, you can compare your projected figures with previous years' to measure your performance.

To boost your business' performance you need to understand and monitor the key 'drivers' of your business - a driver is something that has a major impact on your business.

There are many factors affecting every business' performance, so it is vital to focus on a handful of these and monitor them carefully.

The three key drivers for most businesses are:

Sales

Costs

Working capital

Any trends towards cash flow problems or falling profitability will show up in these figures when measured against your budgets and forecasts. They can help you spot problems early on if they are calculated on a consistent basis.

It's essential to plan and tightly manage your business' financial performance. Creating a budgeting process is the most effective way to keep your business - and its finances - on track.

When you're running a business, it's easy to focus on day-to-day problems and forget the bigger picture. However, successful businesses invest time to create and manage budgets, prepare and review business plans and regularly monitor finance and performance.

Understand your business intimately and exactly where your costs are going to come from.

Be realistic about whether your costs can cover the sales you are forecasting.

Calculate your cash flow when you review your budgets, so you can keep an eye on whether you are running short of cash.

Structured planning can make all the difference to the growth of your business. It will enable you to concentrate your resources on improving profits, reducing costs and increasing returns on investment.

I believe that budgets are best utilized to simplify business. A good business is a simple one, but the inherent challenge all businesses have is that as they grow they become more complex. Applying the 80/20 Rule, four fifths of your revenue will come from just one fifth of your overhead, whether in time or money. It follows that four fifths of your overhead is generating just one fifth of your revenue. In other words directly eating away at your profits.

It is therefore very important to be ruthless in your budgeting. Ideally you want as large a marketing budget as you can because that is what is going to attract and retain customers – the very purpose of any business. If you have £800 of every £1000 spent in overheads bringing home just £200 of every £1,000 made in revenue then it is crazy not to do something about it.

One of my clients, against my advice, moved from their existing premises to much larger luxurious ones where the rent was twice the amount. The rationale was that they could afford it and it would be good for business. After 12 months no new extra business had been generated because of the new premises so naturally they experienced a 50% drop in profits. Premises are an overhead; the costs involved should not be mistaken for a marketing cost. If they had stayed where they were and put the same money that had to be paid in rent into marketing then they would have attracted new business and their profits would have increased accordingly. If more space was then required because more staff were needed to serve increasing custom then that is the right rationale. In my view increasing overhead that does not directly generate new business is irrational.

A penny saved is a penny earned but keeping a business simple must not be confused for keeping a business small. Big businesses that watch the pennies grow bigger, because they invest the pennies saved into budgets that attract customers. Over the next few days look at all the costs of your business with the following simple rule:

Anything that is taking you towards where you want to go is a good cost; anything that is taking you away from where you want to go is a bad cost.

When you have identified the bad costs, eliminate them and invest what you have saved into a marketing budget. Then apply the same rule to your marketing budget: When something works then do more of it; when something does not work, eliminate it. And to know where the budget is working most effectively analyses which 20% of your business is making you 80% of your revenue.