



# Useful Budgets

## —Controlling finances in the new fiscal year

It may seem pointless for us entrepreneurs to make a budget, because the future is uncertain and because we do not consult the budget anyway when making daily decisions, although, with the correct approach, budgets can prove very useful. So, how can we make budgets that will help us develop our business?

Most entrepreneurs are well aware that it is important for a business to have a clear overview of its finances. Despite this many never make a budget, often because they perceive it as a difficult task. Granted, making an accurate budget is difficult, especially because it is often hard to predict the future of a startup business. Regarding turnover, it is often uncertain whether customers will buy and when. Where costs are concerned, at the beginning of the fiscal year, you might not be able to predict future item prices or what you will end up investing in throughout the year. In addition, your expenses will often be dependent upon your turnover. If business is good, you are likely to invest more in the development of your business, and if business is bad you will probably wait. So if the budget is so precarious how can it ever be useful to business owners?

### **Emotional barriers**

Uncertainty about what the future will hold is not the only reason why entrepreneurs hesitate before making a budget. Some feel that they are not competent enough to make a budget, since they are not economists.

However, making a budget is actually not rocket-science, especially not for a smaller startup company. It is really just a question of simple addition and subtraction and multiplying by twelve to get the numbers for the whole year!

In other words, budgeting is simple math of which everyone is capable. The hard part of making a budget is not the math, but the decisions you have to make regarding business operations for the coming year.

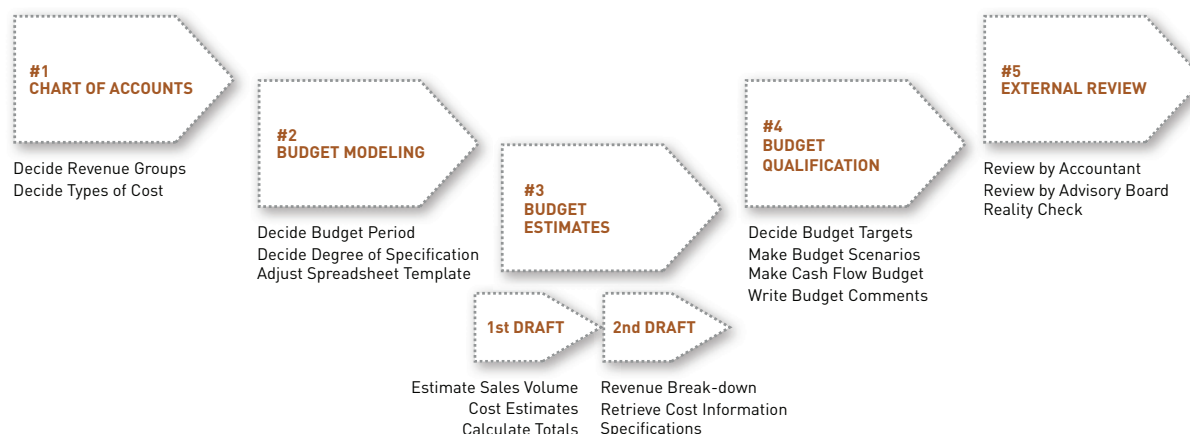
A final reason why budgeting is given low priority by many entrepreneurs is that making a budget can seem boring and uninspiring. However, the creative entrepreneur can make the budget more exciting, also visually, using color charts and graphs to map out historic and future financial figures and developments. This does not help you, however, if you feel that making a budget is a pointless task and a waste of time.

### **So, why make a budget?**

Even though a budget is always just an estimate, a qualified guess really, there are several advantages to making a budget once or twice a year. It may be necessary to make a budget, because it is required by your Board or investors, and it is a worthwhile process to report and get feedback in this way.

However, the most important benefit from making a budget is the decisions you are forced to make regarding your business. In reality, budgeting is not about numbers, but about decisions. For that very reason, the budget is far too important to be left to an accountant, who would be hard pressed to know the future plans for your business intimately enough to predict the right numbers.

### The Budget Process: Decisions about the budgeting process



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### Decisions are the key

The table on the following page presents an overview of some of the decisions that need to be made in order for the budget to be meaningful. These decisions relate both to income and expenses, and some decisions will not be made until later in the year.

One example on the turnover side is the decision as to whether the business should make changes in its product portfolio, its prices, or perhaps its distribution channels in order to maintain or increase turnover and meet projections for the year.

The size of the turnover can also affect how much is invested in sales and marketing. In this turnover group you have to make decisions about everything from advertising to the number of customer visits and the amount of printed matter produced. Similarly, the planned activity level determines all other categories in the budget, not least the personnel budget, where the decision to hire new employees is crucial to both the level of costs, and the amounts you are capable of delivering to the customers.

Finally, another example of a key decision is how to use the projected yearly profit throughout the year. It may be an advantage to invest in branding, product development or better IT-systems, as soon as you have made a profit.

### Five steps to a complete budget

When decisions like these have been made, a complete budget is within reach. One way to get started is by taking one step at a time. There are five steps, illustrated in the model “The budget ladder” on this page.

The first step in the process, before you even begin to consider numbers, is to make a list of the different types of income and expenses in the business. This list corresponds

exactly to the account list used by your bookkeeper, and is a list of all the different types of cost you have in your business.

Therefore the first step is to print the chart of accounts from the accounting system, or to get it from your bookkeeper and to check if it is up-to-date and itemized as needed for the budget.

When your account plan is updated, the next step is to make a *budget model* in a spreadsheet. A budget model contains, first and foremost, a list of the accounts (or cost types) you want to budget for. It can be the complete account plan or consolidated accounts, sales, personnel, administration, and capacity costs etc. Setting up the budget model also involves deciding if you need monthly or quarterly divisions and which budget period you want to cover (6 months, 1 year, or 3 years). If you do not have a good template, it may initially take some time to create a spreadsheet, but once you have made a budget model it can be reused every year with

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only minor revisions necessary. When you have made the spreadsheet, it is easy to throw in some numbers and get an overview.

### Your best guess is your best bet

The third step in the budget process is to put numbers in the various categories. In this part of the process it is vital that you let go of the idea of getting the budget completely right. It never will be and it is not even the primary purpose of a budget. Budgets will always be based on various assumptions so a qualified guess is your best bet.

| CATEGORIES              | EXAMPLES OF EXPENSES (ACCOUNTS) | EXAMPLES OF IMPORTANT DECISIONS                              |
|-------------------------|---------------------------------|--------------------------------------------------------------|
| REVENUE                 | Product Revenue                 | Should the business expand its product inventory?            |
|                         | Service Revenue                 | Should prices and discounts be regulated in the coming year? |
|                         | Sales Revenue                   | Could the business establish new distribution channels?      |
| DIRECT EXPENSES         | Production Expenses             | Can the business lower its production costs?                 |
|                         | Buying                          | Does the business have the right supplier?                   |
| SALES EXPENSES          | Advertising                     | Should you advertise and in which media?                     |
|                         | Travel Expenses                 | How many customer visits per month?                          |
|                         | Printed material and Postage    | What type of marketing?                                      |
| ADMINISTRATIVE EXPENSES | Subscriptions                   | Which media should you keep an eye on?                       |
|                         | Phones and Internet             | Can you get a better price with another supplier?            |
| PERSONNEL EXPENSES      | Salaries                        | Should you hire more employees in the next quarter?          |
|                         | Education/Training Expenses     | Do employees need additional training or education?          |
| CAPACITY EXPENSES       | Office Expenses                 | Should you stay or move offices?                             |
|                         | Cars                            | Should you rent or lease a new car?                          |
| INTEREST & DEPRECIATION | Interest                        | Should you get a loan for a profit generating investment?    |
|                         | Depreciations                   | Should you invest in computer or production equipment?       |
| RESULT                  | Profit                          | What investments should be made throughout the year?         |

A good strategy is to make the budget in two phases, and not to focus on getting it right the first time, that will come later. It is much more important--and fun--to quickly get some numbers to work with.

In the first phase, an easy way to get started is to put in the numbers from last year's annual report and make small corrections. If you do not have annual reports from previous years, you can just put in some more or less random numbers and correct them later. The total, tallied automatically at the bottom of the spreadsheet, will immediately reveal if the numbers are realistic.

In phase two, you can use the overview to try to make the numbers a bit more accurate and realistic. A good way to this is by itemizing or making budgets according to sub-budgets. Instead of making consolidated headings, such as for example marketing, you can specify by breaking them down into 10-20 sub-headings or accounts. It is often easier to budget in this way and the sum of the parts is often more accurate than the larger, comprehensive guess. In the second phase, you can also acquire information about unfamiliar expenses, for example by getting offers from vendors or by asking your network.

### An extra set of eyes

With a rough budget estimate you can proceed to the fourth step in the process; proving the budget, which entails making it as precise as possible by examining the assumptions closer. One way of doing so is, for example, by creating various simulations, that is by changing various pre-conditions and seeing what happens. Spreadsheets are made for this purpose and it is easy to make a visionary budget, a worst-case scenario and a realistic budget somewhere between the two, so that you have several different budget versions. You can also prove the budget by making a small, written report - budget commentary - which explains how you arrived at the budgeted sum.

**“Most entrepreneurs use their intuition when making decisions regarding periodic expenses or investments.”**

The fifth and final step in the budget process to get a third party to review the budget. This role can be taken on by, for example, the business's Board, accountant or bank, but another entrepreneur could also provide valuable input.

In order for an outsider to be able to assess the budget it should include a comparison with figures from earlier fiscal years. It is therefore important to enter the budget into your annual report system, so that you can automatically generate headings in which the budget is seen in relation to figures from previous years.

### **Confidence and intuition**

When the monthly budget can be compared to the annual report figures, the budget begins to be of regular use to us. It provides a financial overview of how well we are doing in comparison to our estimations and it makes us more confident with our own decisions.

Even if we do not use the budget daily, a budget made every six months or yearly will significantly strengthen our financial intuition. This is important, precisely because most entrepreneurs use their intuition when making decisions regarding periodic expenses or investments - the decisions that

help us develop our business and which, in the best case, a good budget can illustrate beautifully.

#### **Suggestions for the next step**

- Make a budget model in a spreadsheet.
- Make an overview of the decisions you will have to make in relation to the budget.
- Make the best possible estimate of income and expenses for the coming year and obtain the information you are missing.

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