# An Introduction to Preparing a Budget

Business Information Factsheet

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## Introduction

Every business needs to have a clear plan for where it is going and what it is trying to achieve. A budget is a financial plan for your business that covers a specific period of time. It is a key element of your business plan as it details the financial performance that you expect your business to achieve. It also ensures that you plan ahead, thus reducing uncertainty about the future and helping you to identify problems before they arise.

This factsheet explains what a budget is and describes the benefits to your business of having a budget. It explains how to prepare a sales and expenditure budget and how to use it to keep control of your business finances. It provides hints and tips and sources of further information.

## What is a budget and why should you prepare one?

A budget is a plan that sets out what you expect your business to spend money on, and where the funds to finance that expenditure will come from. This has the advantage of requiring you to consider the future of the business and gives you something to refer back to regularly to assess whether actual performance varies against your planned budget.

A budget serves a number of purposes in a business, providing:

- A detailed financial plan on which business decisions can be made.
- Financial figures against which actual performance can be compared.
- Information to help you calculate the funding your business needs.
- A framework to manage your business finances effectively.

## How do you prepare a budget?

It is standard practice to prepare an annual budget that covers the 12 months of your business' financial year, which may not be the same as the calendar year.

Preparing a budget for a start-up business is more difficult than for an established business because you do not have a trading history on which to base your budget. You therefore need to make assumptions about how your business will develop and be able to justify your budget figures against these assumptions. Your business plan will be an important starting point for preparing your budget, but you need to be aware that, as you develop your budget, you may identify changes that you need to make to your business plan.

Your budget will quantify, in financial terms, the expected sales income received and expenditure that will be incurred by your business. The main budget areas that you need to consider are:

- Sales income.
- Variable or production costs such as raw materials bought for processing or goods bought for re-sale (which will vary in relation to your sales).
- Fixed or overhead costs relating to running your business such as rent, rates, hire purchase (HP) and salaries (which are largely unaffected by changes in your sales).
- Capital costs, for example for the purchase of computers or other equipment.

## Budgeting for sales

For a new business, budgeting for sales is particularly tricky because you do not have past sales history on which to base your expectations. Instead, your budget must rely on solid research and be closely tied to a realistic marketing plan that will generate the sales you expect (see BIF 236, How to Forecast Sales). You should not just guess your sales figures or look at your planned expenditure and work backwards to derive a sales forecast to cover the costs.

Your sales budget can be split between the different products or services that your business plans to sell. You will need to develop a sales budget for each product or service by considering the following issues:

- The number of units of each product or service that you plan to sell.
- The price that you plan to sell each unit for.
- The different customer groups to which you plan to sell.

After considering all of these points, it will be clear what you are planning to sell, at what price and to whom. You will need to be realistic and cautious about how quickly your sales income will grow in the first few months. Don't be too optimistic - your business may rapidly run out of cash if these sales targets are not achieved (see BIF 58, How to Forecast Cash Flow).

## Budgeting for expenditure

Having prepared the sales budget, you now have the basic foundations for working out what your expenditure will be. There are three main types of expenditure for which you need to budget: variable costs, fixed costs and capital expenditure costs.

### Variable cost budget

Knowing what sales you will make will allow you to calculate your variable costs, which will change in line with your sales. Some of the types of variable cost that you may need to consider are:

- Materials and components that go into the products you sell. For example a cabinet maker would have to budget for the cost of wood, screws, nails, glue and handles and a sandwich shop would have to budget for the cost of ingredients.
- Payments to affiliates, sales agents or staff who earn commission as well as receiving fixed salaries.

Understanding the costs that you will incur for each product or service that you sell is a vital part of preparing an accurate budget. You should prepare budgets for the cost of producing each product or service. You can then review the costs associated with each product to ensure that your proposed selling price generates an acceptable gross profit (the selling price less the variable costs) for your business. This will also help you to identify which products or services are most profitable.

### Fixed cost budget

Once you have prepared the variable cost budget, consider the other costs that your business will incur. These costs will stay more or less constant, irrespective of changes in your sales or whether you make any sales at all. These are often referred to as the 'overhead' costs of your business and can include:

- Rent and business rates.
- Salaries for you and your staff, including employers' National Insurance (NI) and pension contributions.
- Telephone, internet and utilities charges.
- Insurance policies, such as building, contents and public liability insurance.
- Professional fees for accountancy and legal advice.
- Finance costs - bank charges, loan interest, leases, HP agreements, depreciation on equipment and tax.
- Marketing, promotional and travel costs.

If your business is in the manufacturing sector, fixed costs represent a relatively small proportion of your total costs. On the other hand, if you have a business in the service sector, it is quite possible that your overheads will represent a very high proportion, or indeed all, of the costs of running your business.

You need to be aware that once your business is up and running it is often hard to reduce many of these overhead costs quickly. This may be a problem if you do not achieve your expected levels of sales income, so you should aim to keep these costs to the minimum necessary for your business to operate effectively. In particular, you should think carefully before committing to longer term costs such as leases for premises and equipment, which may have to be backed up by personal guarantees. See BIF 232, Leasing Business Equipment, for more information.

### Capital expenditure budget

You will need to buy capital equipment, such as computers or machinery, to use in your business. But what you actually buy will be determined by what you can afford (the budget that you have available) and what finance you are able to raise to help pay for it.

You will need to decide how you pay for your equipment, whether in cash, or with a loan or lease - calculate when you will need to buy it and then budget for these payments in the relevant months.

## Cash flow budget

If you operate your business on a cash basis - taking in cash for your sales and paying cash for your purchases - it will be fairly easy to monitor the flow of cash into and out of your business and you should have cash left over at the end of the month if you're making a profit. However few business owners, even those in the retail sector, operate entirely on this basis. It is far more likely that you will be selling goods or services now, but will not receive payment from your customers until the following month or the month after that. Similarly, you may purchase raw materials or stock, but not pay for them immediately.

Your cash flow budget will therefore use the information from your income and expenditure budgets, but take account of when you expect to get paid by your customers and when you expect to pay your suppliers. It will also show you the implications of buying equipment or repaying any loans on the cash position of the business.

A cash flow budget will help you to identify the amount of cash that you will need to set up and run your business during the first year and whether you can fund this yourself or if you need to source additional funds.

See BIF 58, How to Forecast Cash Flow, for more information.

## Using your budget

You should use your budget as a control mechanism and, at the end of each month, compare the actual figures for sales and expenses with the figures that were budgeted. If there are significant differences between the budgeted figures and the actual figures, you need to understand what caused these differences and take action to remedy it.

For instance:

- If sales are too low, you may need to reconsider your pricing strategy or determine whether one of your products is underperforming against its target.
- If sales are higher than planned you may need to reconsider your cash flow forecast as your working capital requirements (the cash required to fund your day-to-day operations) may increase.
- If certain expenditure is too high you may need to reduce costs - this could involve finding a new supplier.

Your budget, like your business plan, should be an active tool. If you find that the original assumptions you used are not working in practice, you need to be prepared to amend your budget looking forward so that it reflects what you expect to happen. You should be prepared to review, and if necessary revise, your budget every three months during your first year of trading.

## Hints and tips

- Prepare your budget well before you plan to start up so that you have enough time to assess potential financial requirements.
- Look at the impact on your budget if your sales income is 10% or 25% below your expectations. In particular, look at the effect on your cash flow and consider what cost savings you could make.
- If you consult your bank about start-up finance, discuss your budget with your bank manager or small business adviser. This will help you prepare the information in a way that

suits their requirements, giving you a better chance of success in raising the finance you need.

- Remember that your cash flow forecast is as important as the budget itself, as this will alert you to working capital shortfalls.

## Further information

BIF 7 A Guide to Understanding Balance Sheets
BIF 8 A Guide to Understanding Profit and Loss Accounts
BIF 41 Understanding and Calculating Depreciation
BIF 51 A Guide to Controlling Costs
BIF 54 A Guide to Costing and Pricing a Product or Service
BIF 58 How to Forecast Cash Flow
BIF 236 How to Forecast Sales

### Books

'The Financial Times Essential Guide to Budgeting and Forecasting'
Nigel Wyatt
2012
FT Publishing International

'Brilliant Budgets and Forecasts'
Malcolm Secrett
2010
Pearson Business

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