



CATHEDRAL CONSULTING GROUP, LLC

The Budget Process

It is especially vital that each owner is aware of cash needs and designs best and worst-case budget scenarios to mitigate risks. This paper looks to the development of a budget for the next fiscal year.

Purpose of the Budget

The budget and budget process have several purposes that are key to operating a business well.

1. **Budget Process:**

- The process should flow from the strategic plan.
- The process should cause/allow business leadership to determine key steps to implement the plan for the next year.
- The process should incorporate actions needed to address SWOT analysis issues.
- The process should point to the risks and opportunities for the next year.

2. **Budget use:**

- The budget presents a financial picture of the business for the next year.
- The budget's financial picture allows for anticipation of financial and operational issues before the year begins.
- During the year the budget allows measuring actual results against anticipated results for learning and adjusting of operations.
- The budget allows for efficient forecasting of the rest of the year as the year progresses.

Budgeting Methods

Various approaches to budgeting have been developed to address various issues within an institution. All approaches work, but some are easier to apply. Small businesses need efficiency. The following is a summary of an efficient approach for the small business:

1. **Zero-based**

- Zero-based Budgeting starts every year with a clean slate and forces the explanation of every dollar that will be spent. Zero-based budgeting is very inefficient since it neglects the learning cycle from the past. It is designed to minimize budget buildup of expenses found in large organizations.

2. **Bottom-Up**

- Bottom-up Budgeting begins with lower-level management that has spending authority producing the first cut which is followed by discussions with executive management. However, bottom-up budgeting is also inefficient because managers

would like to know what target they are shooting for. The theory is to get the budget closer to the people who know the business.

3. Top- Down

- In Top-down Budgeting the executive management determines the direction and produces the first draft of the budget. It is then sent to the management team for review. This method is the most efficient for small private companies.

The Recommended Budget Process

1. Revenues: Set 2009 revenue targets and review 2008 month by month

- Using the 3 year strategic revenue targets, set the 2009 target.
- To build in seasonality:
 - Review 2008 monthly revenues
 - Adjust for known issues
 - Allocate 2009 target to months based on your 2008 adjusted revenues.
Example: If 2009 revenue target is \$2 million up from \$1.5 million in 2008, that represents a 33% increase. If July 2008 had revenues of \$250,000 then the budget for the same month in 2009 should be \$300,000. If July 2008 was only \$100,000 gross revenues, then 2009 adjusted would be \$133,000 for the same month.
- Tie revenue targets to your revenue generating strategy
 - Review your existing customer/client base for key people or services that might generate higher revenues in 2009. The goal is to identify where revenue is likely to come from. Examples are:
 - 1) Existing Customer/client
 - 2) Price increases to existing customers/clients
 - 3) New products/services
 - Evaluate your potential revenue gap. It will give a sense of the achievable revenue. Budgets should have some level of “stretch:” the target revenue beyond the known achievable revenue. This stretch is the gap. Another way to look at the “gap” is 2008 revenues less 2009 target revenues = the Gap.
 - The gap needs a strategy to fill it. At Cathedral Consulting Group LLC prayer and God’s providence are accepted; but for these purposes, we recommend the farmer’s approach to God’s aid—after praying get busy with the hoe!
 - Develop three strategies for how to fill this gap.
 - Be sure to consider the seasonality of your business as you generate your budget.

2. Expenses: Evaluate line by line to determine which items will increase as revenues grow

- Review compensation to ensure that it is not growing faster than inflation (3.5%)
 - If compensation is growing, look at the reasons, such as:
 - Hired additional people
 - Added benefits and other related costs
 - Provided more work for the same number of people
 - Test for expense growth given revenue growth using a percent of revenue.
Example: If 2009 projected revenue growth is 25%, be sure that expenses are not growing in any area by more than 25%, including compensation. If percentage is higher, this demonstrates a problem.
- Examine the top three costs and determine if you can more efficiently manage them.

3. **Net Income: Review net income as a percentage of sales**

Determine if you are satisfied with your Return on Sales and the efficiency levels of your company. Many clients ask what the appropriate amount of net income should be. While there is no fixed answer the following may be helpful in determining how to set a net income target:

- To an owner the business is an investment
- Net Income is the return on investment (ROI)
 - Return is income/amount invested. Net Income for this purpose is after market level compensation to all workers including owner management (a big issue for smaller private companies).
 - Amount invested can be
 - 1) Book value of equity
 - 2) Value of assets less liabilities
 - 3) Value of business (not usually the better choice since it is circular)
- The return should reflect the risks in the investment.
- *Example: (Book value) \$3 million by (target return) 16% = (Targeted Net Income) \$480,000*
- Target returns for 2009 are:
 - Risk free – US Treasury 10 yr Notes are 3.8%
 - Public company expects 16%
 - Private company is generally higher than public ROI.

NOTE: All this is pre-tax.

- Many companies may find this income amount quite high. Part of the reason is the need to:
 - Better manage the business using ROI thinking.
 - Compensation to owner may be high thereby including what would be return on investment.
 - The business may be one with no returns. This does not make it bad, but low returns do affect value.

4. **Budgeting Cash Flow**

To budget cash flow you first have to budget using full financials. (See the April topic on Financial Statements for further details.)

- Income Statement (what is usually done)
- Balance Sheet
- Cash Flow Statement

The Cash Flow Statement starts with budgeted net income then adjusts for changes in the Balance Sheet. The change in the Balance Sheet tells what operating cash will be used to sustain the budget. For example, revenue growth by 10% may mean 10% increase in Accounts Receivable, which must come from operating cash flow or borrowings.

Budget vs. Forecast

A budget is the goal that you have for the year for both revenues and expenses. It does not change as the year progresses. It should be compared to actual revenue and expenses on a monthly basis and any differences explained. This explanation in turn helps your company to respond to market conditions (positive and negative) and to fine-tune your forecast for the next quarter and year to year.

Articles for Further Reading

1. Building a Financial Budget—This article provides practical tips for the budget process. (<http://www.entrepreneur.com/money/moneymanagement/financialanalysis/article21942.html>)
2. Q&A: Seeing Beyond the Annual Budget-- This article describes the “big company” issues in budgeting. (<http://www.inc.com/articles/2003/09/qahope.html>)
3. Best Practices: Developing Budgets – This article provides background on the why and how’s of larger company budgeting. (<http://www.inc.com/articles/2000/01/16379.html>)
4. The Employee-Run Budget Worksheet – This article explains why budgets help a company and argues for the zero-based approach along with providing a sample worksheet for this method. (<http://www.inc.com/tools/2000/10/13788.html>)
5. Budgeting for the Small Business—The Small Business Administration compiled this detailed article on budgeting along with many specific examples in the appendix. (http://www.sba.gov/idc/groups/public/documents/sba_homepage/pub_fm8.pdf)
6. Get Some Class: Useful and Usable Budgets – This article explains how to use classes in QuickBooks to maximize the breakdown of categories and assign employee responsibility. <http://nyreport.com/index.cfm?fuseaction=Feature.showFeature&FeatureID=733>

Not Covered in this Budget Discussion:

1. Software tools for budgeting
2. Tying budgets to compensation
3. Multiple scenario budgeting

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