



Budgeting Basics

**A workshop about building a budget as a critical tool
for greater profitability and business success**

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Learning Objectives

By the end of this workshop, you will:

- Understand the fundamentals of budgeting.
- Know how to use a budget to effectively manage your business.
- Learn how to create and maintain a budget.

What is a Budget?

- A budget is a plan for revenues, expenses, and profit over a certain period of time.
- Typically an annual budget is developed and broken down by quarters, months, or weeks.
- A budget is a financial projection of your business (based on current assumptions) taken as a snapshot at a point in time.
- A budget should be aligned with your business purpose or mission.
 - When doing the budget, are your decisions moving you closer to your purpose or mission or moving you away from it?
- Research has shown that having a budget:
 - Allows you to see if you have problems on the horizon.
 - Gives you a greater sense of control because you can better deal with financial issues as they arise.

Budget Fundamentals

Approaches to budgeting - Businesses commonly use two approaches to guide their budgeting efforts:

- *Historical Budgeting* – the historical approach to budgeting uses reference to a previous budget to prepare a new one. The previous budget is used as a starting point, and is then adjusted to take into account the expected effects of inflation, growth, or other pertinent changes.
- *Zero-based Budgeting* – zero-based budgeting is an approach that requires planners to start the budgeting process from scratch each time a budget is prepared. The effectiveness of each activity must be justified before being included in the budget.

Budget Fundamentals

Historical Budgeting is based on assumption. It assumes that business variables and the organization's strategy stay essentially the same from budget period to budget period.

- *Advantages:*
 - Saves time
 - Saves money
 - Incorporates the experience of what works and what doesn't
- *Disadvantages:*
 - Doesn't provide an opportunity to challenge or rethink the status quo
 - Perpetuates inefficient and unnecessary practices

Budget Fundamentals

Zero-based budgeting - operates on the premise that each new budget needs to start from scratch, or point zero. This encourages businesses to reconsider the value of budget activities and think of alternative ways to achieve the goals.

- *Advantages:*
 - Allows for innovation and change:
 - Each activity outlined in the budget plan is approached from a fresh perspective
 - Opens the door to the development of new practices and methods
- *Disadvantages:*
 - Time consuming and costly

The best approach may be a combination of the two.

Budget Fundamentals

Business budgets are “balanced”, i.e., revenues minus expenses equals profit/net income.

Gross Income	600.00
Cost of Goods Sold	<u>300.00</u>
Gross Profit	300.00
Operating Expenses	
Supplies	25.00
Depreciation	55.00
Education	50.00
M&E	85.00
Travel	<u>75.00</u>
Total Operating Expenses	290.00
Net Income	<u>10.00</u>

Budget Fundamentals

The best budgets use the “**nuts and bolts**” operational data that you deal with every day in running your business:

- **Revenue:** # of children served at \$ rates
- **Expense examples:** # of employees at average \$ hourly rates, # of materials used at average \$ cost, rent/mortgage payment, etc.

Budget Fundamentals

There are three different types of expenses in budgeting; understanding each of them can help you decide what's important as you develop and monitor your budget:

- Controllable (Variable)
- Semi-controllable (Semi-variable)
- Fixed

Budget Fundamentals

Controllable (a.k.a., Variable) expenses are discretionary in nature and can be increased or decreased by management decisions.

- **Controllable expenses include:**
 - Salaries
 - Travel
 - Supplies
 - Printing
 - Consultants or Contractors

Budget Fundamentals

Semi-controllable (a.k.a., Semi-variable) expenses appear to be uncontrollable but are to a certain degree. Payroll taxes are controllable to the extent that salaries are controllable; if salaries decrease, payroll taxes decrease.

- **Semi-controllable expenses include:**
 - Fringe Benefits
 - Utilities
 - Payroll Tax
 - Insurance

Budget Fundamentals

Fixed expenses are the result of contractual agreements.

- **Fixed expenses include:**
 - Rents
 - Lease contracts
 - Mortgage or Loan Interest
 - Maintenance or Fuel Contracts

Budget Fundamentals

- Typically, expense budgets are more easily created than revenue budgets because your commitments are known quantities.
- Be conservative when budgeting revenues. Include a small amount of **contingency** for unexpected expenses to increase your chances of maintaining a positive cash flow.
- Budget your revenues on a **cash basis**, i.e., budget revenues in the period you will receive payment, not the period in which you performed the work or sold the goods.

Budget Fundamentals

- Use your budget **regularly** as a roadmap to operate your business.
- **Share your budget with your staff.** If they know what the business goals are, they can help you get there. Often the best ideas for improvements come from the people closest to the work.

Testing your knowledge...

Answer the questions on the handout *Testing your knowledge in budget fundamentals*

More Budget Fundamentals

Once the budget is set, it is used to monitor progress. This can be done through **variance analysis**.

- **What is a variance?**
 - **Variance** is the difference between what actually happened and what was planned in the budget.
- **Why are variances important to monitor?**
 - If variance exists, you can take action.

More Budget Fundamentals

Types of variances:

- *Adverse* - Typically, adverse or negative variances are investigated so that corrective action can be taken to get the organization back on track with its goals.
- *Favorable* – Favorable or positive variances are less likely to be investigated. But if the positive variance is abnormally high, it may be scrutinized.

More Budget Fundamentals

A tool for exploring variances is the **variance report**.

- **Typically, the report identifies:**
 - The budget year
 - The budget items being monitored
 - Actual performance results
 - Planned performance results
 - Variance. Variance is likely to be recorded both as the **dollar** difference between the actual and planned results and as the **percentage** of that difference.

More Budget Fundamentals

Using the variance report:

- The variance report should be run at **consistent** intervals.
- Knowing when to investigate a variance depends on several factors:
 - Size – Is the variance large enough to warrant investigation?
 - Likelihood of recurrence – Is the variance likely to occur again? Did the variance happen in the past? Is this a trend?
 - Controllability - Consider whether the variance is controllable. Regardless of size, only those variances that can arguably be controlled are worth investigating.

Depending on what you learn during the investigation, the original budget may be revised or action may be taken.

Testing your knowledge...

Answer the questions and complete the exercise on the handout *Testing your knowledge in budget fundamentals – variance analysis*

Budgets are Critical to Success

A budget is critical for five primary reasons:

1. A budget helps you predict cash flows and avoid surprises.
2. A budget shows your banker/investors/funders how you plan to pay back a future loan or effectively use a grant.
3. A budget quickly highlights areas that need improvement.
4. A budget helps you keep your operations running smoothly.
5. A budget helps you project the future and take actionable steps.

Reason 1. A Budget Helps You Predict Cash Flows and Avoid Surprises

Because you build a budget from your projected operational data, it includes the expected ups and downs (seasonality) in your revenues and expenses.

- A budget is especially helpful if:
 - You have alternating slow/busy seasons.
 - Your revenue stream comes in huge chunks followed by long periods of no revenue.
 - You have expenses that vary greatly month to month.
- By knowing when you will have excess cash and when you will have more expenses than cash coming in, you can plan for when your cash levels will be low.

Reason 2. A Budget Demonstrates Stability and Sustainability

- A budget signals to potential lenders/funders that you have planned and know what it will take to pay a loan back in a timely fashion or use a grant successfully.
- A budget also gives investors something to react to; they can compare your revenue and expense plans to industry norms to see if they are reasonable.
- Lenders/funders are not likely to loan you money or provide a grant unless you have a budget backed up by reasonable facts.

Reason 3. A Budget Quickly Highlights Areas That Need Improvement

- Use your annual budget to compare actual revenues and expenses every month.
- Revise your budget to take into account major changes in your business, but remember to keep it balanced.

Reason 4. A Budget Helps You Run Your Operations Smoothly

Because the budget is built by using operational data, the two should always be in sync; if you have a variance, then something in your operations is driving the change.

- If your revenues are under budget, take a look at the data you used to build the budget. Were your assumptions correct?
- If your projections are off, you may need to make operational adjustments.

Some adjustments that can be made:

- Adjusting staff schedules
- Adjusting fees
- Enforcing payment terms

Reason 5. A Budget Helps You Project the Future & Take Actionable Steps

A solid budget helps you answer the following questions:

- If demand for your business is growing, and you are reaching the limits of your existing staff, how do you know when to add that next employee?
- If you want to purchase new equipment, but an upfront initial investment needs to be made, when is the best time to make the purchase?

Creating the Budget

It's a process:

- Examine the past year
- Develop next year's goals
- Determine the budget approach
- Create a timeline for developing the budget
- Have a budget meeting
- Create the budget
- Review the budget
- Have another budget meeting

Creating the Budget

- **The mechanics of budgeting:**
 - Determine the line items
 - *Income* – operating and non-operating
 - *Expenses* – controllable and fixed
- **Develop supporting worksheets**
- **Justify – make notes about assumptions**
- **Calculations – be consistent (same units)**
- **It's Math!**
 - Learn to love Microsoft Excel

Creating the Budget

In child care budgeting it is important to understand your **utilization rate** – the program’s rate for actual usage (enrollment, attendance, and fee collection) in relationship to capacity.

- The utilization rate is your best estimate of the *percentage* of full enrollment for the year:
 - Full enrollment = 20 kids x \$500/month or \$120,000 in fees.

Creating the Budget

To calculate the utilization rate for budgeting in the current year consider what percentage of full enrollment was achieved over the past several years.

- In each year, divide actual enrollment fees earned by potential enrollment fees
 - 2013 - $\$112,000/\$120,000 = 93\%$
 - 2012 - $\$108,500/\$120,000 = 90\%$
 - 2011 - $\$115,200/120,000 = 96\%$

The Average
utilization rate = **93%**

**Do not budget fee
income any higher
than 93% of full
enrollment!**

Things to Keep in Mind As You Create a Budget

- Create manageable and meaningful categories of revenues and expenses; they should mirror how you currently track income and expense.
- Check your budget against your industry's financial information to see if your business is in line with industry averages; if not, find out why or make necessary adjustments.

Applying your knowledge and skills...

- Use the case study for **ABC Child Care** to create a line item budget for the center.
- Reflect on the presented questions after creating the budget.



Key Takeaways from This Workshop

- Creating a solid budget by using the key operational data you use to run your business will help you make important decisions about your business.
- Comparing your actual financial results against your budget every month and noting the variances, is extremely important.
- Using your actual versus budget variances will help drive improvements and plans for the future.



Key Takeaways from This Workshop

- A business budget is a financial roadmap to success, a vision of where you want to take your business for the upcoming 12 months.
- A budget helps you measure success; it tells you where your business is working and where it might be veering off course.
- Best practices can help you to successfully build and maintain a budget and, ultimately, increase your company's profitability.

Budgeting Resources

- **Budgeting basics and budget templates:**
 - First Children’s Finance -
www.firstchildrensfinance.org/businessresourcecenter/centers-2/finance/finance-tools/
 - ECE Shared Resources (Membership required.) -
<http://elnh.ecesharedresources.net/Budget.aspx>
 - New Hampshire Center for Nonprofits *NonprofitNext* (Membership Required.) -
<http://www.nonprofitnext.nhnonprofits.org/>
- **Publications:**
 - *The Bottom Line for Children’s Programs* by Gwen W. Morgan and Bess r. Emanuel

References

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