

Business guide

Writing a business plan

How to start your new business
off on the right track.



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Why budget?

A budget is just a special kind of plan or 'map', usually for at least one year ahead. It shows your business operations in terms of expected income and expenditure. It requires you to have an overall mission or direction, especially one that involves the achievement of specific objectives or targets. These targets have to be measurable – budgets always involve numbers and they always specify a period of time or milestones.

A budget does three important things:

- It helps you understand what you must do, and by when, in order to achieve your targets.
- It helps you track your monthly progress so you can make adjustments as you go, which will dramatically raise your chances of achieving your goals.
- It also gives you early warning of when you are drifting off course so you can take corrective action before things reach a crisis.

So, a good budget helps you:

- Clarify your own planning.
- Communicate your plans to other people – both within your business and to important outsiders, including shareholders, financiers and your bank manager.
- Create a yardstick or benchmark to measure your progress against.

Different types of budget

There are several different types of budget, but here we will concentrate on sales budgets and profit and loss budgets, as these are simple to understand and cover issues that are important for a small business.

Cashflow forecasting is also vital for any business of course, but since this is based upon your budget forecasts, you need to understand the basic principles of budgeting before you attempt this.

Your approach

If this is your first attempt at budgeting, you will use what is called a zero-based approach. Zero-based budgeting involves starting with a blank sheet of paper and translating your plans and assumptions into figures.

In future years, you might be lazier and simply apply percentage changes to your previous year's figures (in what is called the historically-based approach). The latter is acceptable for many cost items. However, there is still a lot to be said for going back to first principles each year, especially for sales figures.

Your budget should reflect your business goals and ambitions. If you have hands-on experience of your marketplace, try to be honest with yourself and strike a balance between what is realistic and what is challenging. If you have no hands-on experience, your first task should be to find and befriend someone who has so that they can guide you and provide a sanity check.

Preparing for best and worst cases

If you are not sure of your figures, you might like to calculate three separate budgets for best and worst cases, plus your best guess somewhere in the middle. Using this method, you can think through the implications of these scenarios and prepare accordingly.

The basics of budgeting

Do annual budgeting for your sales month by month, listing the months across the top of your spreadsheet. You need to do it this way as most businesses have a seasonal pattern to their sales, so an annual figure divided by 12 will not be realistic. For long-term budgets, quarterly figures are fine.

It is more efficient to use a computer-based spreadsheet for your budgets. This speeds up the calculations and makes working out various best and worst-case alternatives much easier. If you are not used to using spreadsheets, get someone who is to check your calculations and assumptions.

Do not worry if you don't have access to a computer spreadsheet, though, because there should be nothing here that you cannot work out with a calculator.

Step 1 – the sales budget

For each product (or product group if you have lots of products), ask the following two questions. Be honest with yourself:

- How many units are you planning to sell each month?
- At what net price? Don't forget to deduct any special deals or discounts.

Enter your results in a table like the one below:

- Calculate the sales value for each month.
- Calculate a total sales value row at the bottom for the whole business.
- Add up the 12 monthly columns to get totals for the year.

TABLE 1	Jan	Feb	Mar	Total
Product A					
Sales Units (Ua)	1,000	1,500	3,000		21,000
Selling Price (Pa)	50	50	40.50		-----
Sales Value (Va = Ua x Pa)	50,000	75,000	135,000		995,000
Product B					
Sales Units (Ub)	500	400	600		6,000
Selling Price (Pb)	90	90	80		-----
Sales Value (Vb = Ub x Pb)	45,000	36,000	48,000		510,000
Total Sales Value (Va + Vb)	95,000	111,000	183,000		1,505,000

U = Units sold, P = Price per unit, V = Sales Value

To keep things simple, we have shown only two products and three of the 12 months included in the totals.

In this example, you are not planning for selling prices to increase during the year, and are actually expecting to discount them in March for your annual sale.

We have also assumed the budget runs from January to December. However, if your year-end were March, for example, you would need to amend the layout accordingly.

Even this simple step has forced you to make a commitment and has given you something to measure your progress against. It also reveals other things. For instance, you need to plan how you will handle the increased sales volume in March and what stock you will need to buy – and pay for.

Step 2 – using your sales budget

Once you have prepared your budget every month, plot your actual performance against the budget. This is called a variance report.

If you have computerised accounting software, you should be able to feed in your monthly figures and it will produce variance reports for you, both for the month in question and cumulatively for the year to date. If not, you can construct your own report, as in our next example:

TABLE 2	Jan	Feb	Mar	...
Month				
Actual Sales	80,000	105,000	190,000	
Budgeted Sales	95,000	111,000	183,000	
Variance	(15,000)	(6,000)	7,000	
Year to date				
Actual Sales	80,000	185,000	375,000	
Budgeted Sales	95,000	206,000	389,000	
Variance	(15,000)	(21,000)	(14,000)	

To produce this:

- Each month enter actual figures in the top row from your sales records or accounting system.
- Bring down the bottom line of the sales budget (Table 1) above into the monthly budget row.
- Subtract budget from actual to get the variance row.
- For month 1 (Jan), carry these figures down into the YTD section.

In subsequent months, add the monthly figures to the previous month's YTD figures.

Whilst in many ways the YTD figure is the one that matters, you can often pick out a trend by looking at the monthly variances. For example, the February YTD variance above looks bad, but the monthly figure is actually an improvement on January.

Step 3 – profit and loss budget

Whilst sales are vital, to make sure that you will actually make an overall profit you need to create a budget to monitor your costs as well as your sales.

The profit & loss budget is calculated by taking the sales value and deducting all the costs you incur during the year to run the business.

Cost of sales

The first costs you must assess are those of the products you are selling plus the costs of making them available for sale.

- If you buy in the product, this will be based on the price quoted by your supplier. However, you will need to add in any cost of delivery to you, including insurance and customs duty for imported goods.
- If you manufacture the product, you will need to calculate a unit cost of production, which will include the cost of raw materials and labour used.

- Include other direct costs of production such as electricity and maintenance costs for any machinery used. (These will probably have to be averaged across a weekly or monthly number of units.)
- Other sales costs may include storage, sales commissions, outward delivery and packaging – ie every cost that is directly attributable to sales. If you do not feel confident assessing all these yourself, get help from an accountant or business adviser.

To calculate the cost of sales:

- Enter the unit cost in column 3 of the table below and other costs of sales in column 4.
- Bring down the total units you plan to sell in the year for each product from the sales budget (Table 1) into column 2.
- Add the unit cost (column 3) to the other costs of sales (column 4). Multiply the result by the number of units sold to give a cost of sales for each product in the last column.

TABLE 3	Units Sold	Unit Cost	Other Costs of Sales	Cost of Sales
Product A	21,000	24.8	5.2	630,000
Product B	6,000	37.4	2.6	240,000
Total Cost of Sales				870,000

Gross profit

Gross profit is the surplus of turnover after sales costs.

- Take the total annual sales value from the sales budget (Table 1) – sales value is also often referred to as turnover – and copy it into the table below.
- Bring down the cost of sales from Table 3

- Deduct cost of sales from turnover to get gross profit.

TABLE 4			
Sales value (Turnover)	[T]		1,505,000
Less Cost of Sales	[C]		870,000
Gross Profit	[G = T-C]		635,000

Net Profit

To find your real profit, you now need to deduct your other costs that are not directly linked to units of production. An example would be rent, which will probably not be any different if you sell 600 or 900 units. These are called fixed costs or overheads.

Bear these points in mind:

- Remember, while they are only fixed in relation to sales, most of them usually change over time, although costs like office rent might be fixed for at least a year ahead.
- When budgeting, it is important to include everything and to make a realistic provision for each item.
- Most people starting up businesses seriously underestimate a lot of these overhead costs.

You need to include:

- All your indirect selling costs, including marketing, advertising, trade shows and so on.
- All your office and property running costs, including cleaning.
- Any costs of employing people, including their benefits.
- Professional fees, including legal and accountancy fees.
- Financing costs such as interest and bank charges.

Note: if you are a manufacturer, be careful not to double count things like labour costs and electricity that you have already built into your cost of sales.

Depreciation

There are many, usually expensive, items that are needed to run a business such as furniture, cars, computers, machine tools and so on. These are called capital items or fixed assets, and their purchase cost is not included in the budget. Instead, there is a special charge that accountants call depreciation. This is not an expense as such because it doesn't involve parting with any cash, but it does represent an estimate of the proportion of the value of your fixed assets that is used up during the year.

For example, if you buy a new machine every four years, and the last one cost you 10,000, you should include a depreciation charge of 25% of this 10,000, i.e. 2,500 in each of the four years.

Let's extend our table with a few overhead items. Your list of items will probably be much longer, but this example is merely to illustrate the format.

Add up all the Overheads and deduct from your Gross Profit to give a Net Profit of 188,000 for the year.

TABLE 5 % of Sales

Sales value (Turnover)	1,505,000	100%
Less Cost of Sales	870,000	58%
Gross Profit	635,000	42%
Less Overheads		
Office/management salaries	210,000	
Rent/rates	35,000	
Selling costs/advertising	95,000	
Telephones	18,000	
Electricity	12,000	
Postage/Stationery	19,000	
Professional fees – legal and accountancy	21,000	
Interest paid	15,000	
Depreciation	22,000	
Total Overheads	447,00	30%
Net Profit	188,000	12%

Step 4 – using your profit and loss budget

Take Table 5 and add two extra columns – one for actual figures and one for variance.

- The actual figures again come from your accounting records.
- The variance is calculated as the difference between the actual and budget column figures.

TABLE 6 Actual Budget Variance

	Actual	Budget	Variance
Turnover	1,450,000	1,505,000	(55,000)
Cost of Sales	(850,000)	(870,000)	20,000
Gross Profit	600,000	635,000	(35,000)
Overheads	(475,000)	(447,000)	(28,000)
Net Profit	125,000	188,000	(63,000)

Note that if turnover or profit is less than budget, the variance is negative.

However, if costs or overheads are less than budget, the variance is positive – which is good for business.

Table 6 gives you a simplified overview. Clearly, you would get more information by analysing the overheads line by line. The object of this approach is to spotlight variances in the detail of your sales or cost information to explain any difference in your net profit.

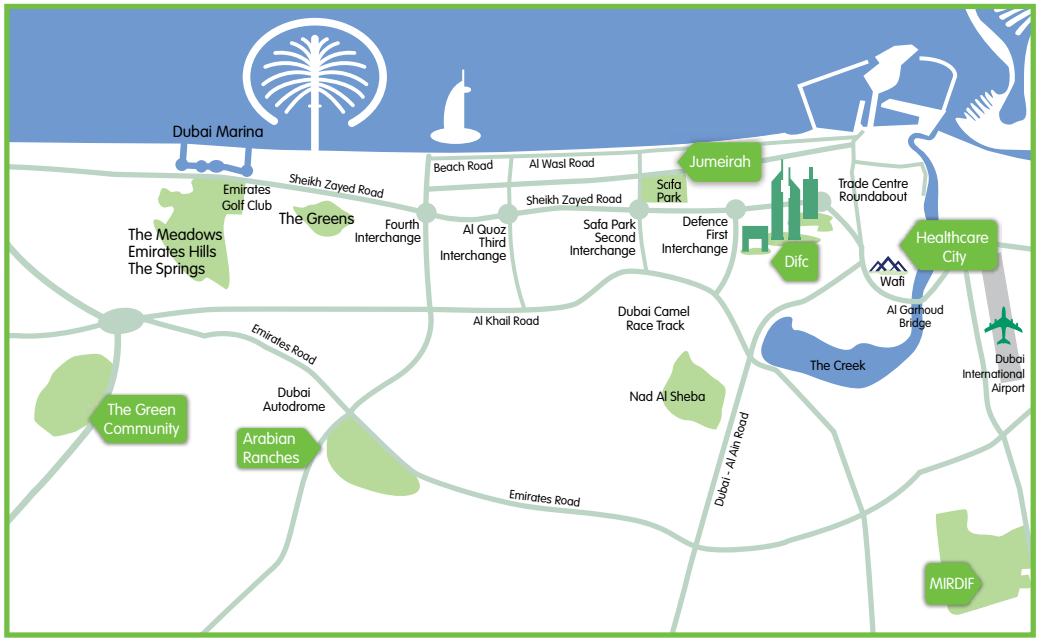
Once you can identify your problem areas, you can start to do something about them.

Cashflow

Just as important as your profitability is your cashflow. You can't sell things unless you buy or make them, both of which may involve paying out cash before getting any return from them. Most businesses that fail do so because they run out of cash, often despite showing good profits. Cashflow problems can also arise in seasonal businesses or those with slow debt collection.

So another vital table is a cash flow forecast, where you list all your cash inflows and outflows when you expect them to occur. This will highlight those periods when you may need a temporary overdraft.

Budgeting is a logical process. However, if you don't know all the figures to begin with, use your best guesstimate until you can find out or experience shows you. Budgeting is also a rewarding process because it puts you in the driving seat and allows you to run the business, rather than vice versa.



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