

Five and a Half Steps to Your First Budget

By Stephen King

Over the past 20 years it has amazed us how many small businesses don't have an operating budget. Creating a budget is one of the most common unfilled goals of small business owners. Everyone wants one but many can't get it done. Why? Because business owners think of budgeting as a major undertaking - so it never gets started. This article spells out five and a half simple steps for getting one done in a few hours.

STEP 1. GET THE RIGHT MINDSET

The biggest obstacle to budgeting is between the ears. Many never get a budget done because they try to get it perfect. Budgeting is predicting the future—which by definition means its going to be wrong. Don't spend a lot of time trying to make the perfect plan. Just get started and next quarter you'll be a bit smarter.

If you still don't have a budget for this year yet, its not too late. Create something so you are comparing actual results against plan. That's better than waiting until you have the time to get it just right. Just get started.

STEP 2: FORECAST REVENUE

Since we've already agreed you can't predict the future just jump in and take a SWAG at forecasting revenue. The revenue forecast process you follow is based on the amount of data available and the time you want to spend. The first time just take a stab, recognizing that each quarter your ability to foresight will be better.

Since our clients don't have much time and use QuickBooks, here's a process we recommend:

1. Export actual profit and loss, by month for the last 12 months, from QuickBooks into Excel. From the reports menu choose: Company and Financial, Profit and Loss Standard. Change the dates and then change the Columns field from "Total Only" to "Month". Hit Export to Excel and now you have the last year, by month, as a start for this year.
2. Then copy last year's actual results and paste to give a starting place for this year's plan. Its easier to change a spreadsheet than to start from scratch.

3. Then decide how much detail you want for your revenue forecast. You can go two ways: project revenue "top down" (3 below) with a simple percentage increase over prior year; or define the primary drivers the impact revenue and build a forecast model from the "bottom up" (4 below).
4. Top Down—this is the simplest way to forecast revenue: simply set a revenue growth target as a percentage increase over the prior year. Its easy to explain to others and the fastest way to get it done.
5. Bottom Up—this method involves analyzing the drivers that impact your revenue stream. For example, if revenue is a function of number of clients times the average revenue per client, set up rows in Excel for each driver and plug in an initial set of assumptions by month. Then let Excel do the math: number of clients times average revenue by type of client equals revenue target per month.

STEP 3: SET COST OF GOODS AND GROSS MARGIN TARGETS

Once you set an initial revenue forecast its time to define your target cost of goods sold (COGS) and gross profit margin. The easiest way to budget COGS is to set a target gross profit percentage and work backward. Start by adding a 'gross margin percentage' row to the Excel sheet of your prior year Excel spreadsheet (gross margin/total revenue). This gives you last year actual gross profit as a percent of income.

From there you can set a new gross margin percentage target and work backwards to forecast COGS as a percent of income. COGS for many businesses is direct labor and/or direct material. In this time of rising costs make sure you adjust your COGS target based on next year's realistic projected costs.

Of course you can build a detailed cost structure for each product and link the labor and material costs to the forecast of products/services sold—but we're assuming if you've read this far you don't have your first budget yet. So for the first pass just KISS—Keep It Simple Steve and just get 'er done.

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STEP 4: EXPENSE BUDGET

Once revenue targets have been defined and you have taken a stab at setting gross margin percentage targets, then its time to create an expense (overhead) budget. Again this should be based on prior year actual results.

Start by ask the following question: how will expenses change based on changes in revenue? To quickly answer that it helps to sort the expenses in your Excel file by behavior. Hopefully your chart of accounts summarizes your discretionary (sales & marketing, product & industry) expenses separately from non-discretionary (general & administrative expenses). If not, do this:

1. First scrutinize last year's non-discretionary spending in order of spending so most expensive budget items get the greatest scrutiny. Make sure they truly are non-discretionary and enter the amount you expect to spend next year. This is what you need to keep the business running, lights on.
2. That just leaves a review of discretionary spending. Review each amount in order of amount, so that the most expensive items get the greatest scrutiny. Decide what you really want to spend and plug it in.
3. Summarize total projected overhead spending.

STEP 5: RECONCILE TOTALS & START TRACKING

Often the first cut of a budget results in spending greater than the income projections. If you have a negative bottom line, repeat steps 2 through step 4 until your bottom line is balanced with revenue targets.

In budgeting the process is more important than the result. Once you have completed your first budget its time to start tracking actual versus your plan. Quick-Books has a simple budget entry screen (Company, Planning and Budgeting, Set up Budgets) which allows you to enter a budget for the company, by class (department) or customer/job.

Start by entering the first quarter's budget into Quick-

Books and share it with your staff. If you create incentive compensation goals based on hitting plan you'll find your staff will start acting like owners and your internal reporting to be much more meaningful. Next quarter you'll be smarter about forecasting. By next year you'll wonder how you ran your business without a plan....

STEP 5.5: PREPARE A SALES PLAN

If you are ambitious, or just like to focus on sales, you can also prepare a sales plan. While a sales plan is not formally part of the budget, it can be critical part of the plan to reach your revenue targets. Taking this step gives you a better ability to track how you are doing against a sales plan.

Since income is the engine that drives all business, we suggest you work backwards from your revenue goals. The sales plans helps define where those sales are going to come from. If your sales cycle is two months to close a new client you'll know two months in advance whether you are likely to hit your revenue targets – which gives you time to do something about it. Simply follow these five steps:

1. Identify the number of phases in the sales funnel (how many steps to get a new client?) Lists each steps in your sales funnel. A typical funnel has the following phases: Receive lead; Contact, qualify & convert to a prospect, Send proposal & follow up, Close and receive deposit from new client.
2. Estimate the percentage conversion for each level.
3. Based on the funnel conversion rates work backwards to determine how many new leads you need to reach your revenue targets. For example, we expect to convert 24 leads to 12 clients each month. Now we have something to track.
4. Estimate marketing costs required to reach targeted number of suspects. Drop those costs into your marketing budget (Expense Step 4 above)
5. Share revenue & pipeline targets with the staff.

That's it. Its easy once you get started. If you need help preparing a budget let us know. We've got a network of Virtual CFOs just ready to help you grow.....