How to create a budget

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It's not glamorous, but a budget will help manage costs, identify red flags, and achieve profitability.

Between 2004 and 2007, Apex facility resources, a Seattle furniture dealership and relocation company, experienced a 900% jump in sales. Yet the owners, Marlaine McCauley and Matt Watson, didn't know if they'd actually made any money. "We didn't have any kind of operating budget when we started growing," says McCauley. "We just threw people at growth," hiring more and more salespeople rather than looking at the bottom line. "We tried to invest in some accounting systems, but it didn't work. We didn't really know where we were as a business."

Like McCauley and Watson, plenty of entrepreneurs prefer to focus on boosting the top line rather than wade into the nitty-gritty of financial management. "I ask my clients how much money they make, and the answer is always, 'I don't know, it depends on how the business does,'" says Heather Hutchinson, principal at Hutchinson & Ziegler Financial Advisors in San Rafael, Calif. "Entrepreneurs often start their business and run it without a clear idea of what they are going to get out of it."

For Apex, the failure of that strategy became abundantly clear last year: The 61-employee business hit a high of $10 million in revenues, but "we didn't have anything on the net side," says Watson. The company wasn't broke, but it wasn't turning a profit, either.

Creating a budget is not glamorous. But a budget can help you gauge profitability, manage costs, and easily spot red flags. And it's especially prudent to know your numbers inside and out in today's economic environment. "During a 'regular' business cycle, you can count on certain revenues and customers and pricing," says Larry Cox, associate professor of entrepreneurship at Pepperdine University. "Of course, we don't live in that kind of world anymore. You can't predict a big bank bankruptcy."

In some cases, a comprehensive budget may help reshape your company entirely. Brian Milburn, owner of Milburn Group Interior Design, a $1 million, three-employee San Diego firm that recently moved to a tightly managed budget after using a more laissez-faire operating system, says the switch has permanently changed his company: "Business is going to be different for us. We have found a very lean comfort zone, and our overhead is low and our value high to the client. We won't go back."

The best-laid plans, of course, can fall apart. Even if you think you've got your budget figured out, it's critical to be flexible and even have a secondary budget to fall back on.

To get a better grip on your numbers, you first need to figure out what your company is trying to achieve financially. Then evaluate every dollar that goes in or out. Once you have a thorough understanding of expenses and income, you'll be able to create a base budget you can use to predict and guide your year ahead.

Although it may seem obvious, you need to go beyond setting goals: You need to quantify them before you can set a budget that will help you get there. Is your aim to hit $1 million in sales? Or to achieve a 20% margin? Or to take home a salary of $200,000 a year?

Starting from the bottom line, or even a personal financial target, rather than a sales goal, can be motivational for a business owner. But sometimes the object can be as simple as not losing money. Last year "was an eye-opener because we had such a good top line, but we had so much fat and were misreporting and inaccurately managing our costs and revenues," says

Watson, who is vice-president for business development at Apex. "So our initial goal for 2009 was to break even, which meant we had to sell $600,000 a month."

Build a history

A detailed understanding of your expenses and sales is the cornerstone of any effective budget. Pull your financials going back at least two years and pay special attention to seasonal fluctuations. What are your biggest sales months? When are the downtimes? When do your costs spike? What percentage increases have you seen in specific costs and sales?

Don't look at the numbers in a vacuum. "Make it a group effort," says Lisa Coston, senior audit manager at Daniells Phillips Vaughan & Bock in Bakersfield, Calif. "

Allow department heads to understand the process and have a role in shaping it. Maybe the accountant is looking at all your historical numbers, but the marketing department will have a different perspective. Ensuring that you're including everyone will help you get your arms around these costs."

For Apex, obtaining an accurate financial history meant replacing the company's controller and hiring someone experienced in developing and tracking financial data. The new hire's first task was to look at historical numbers and make sure costs were classified in their proper budget lines. Even before putting a budget in place, the efforts yielded fruit: The company was able to save $7,000 on its insurance premium, because the premium is tied to employee salaries, and salaries of some of the warehouse employees were being classified incorrectly.

The examination also helped the owners see where they were actually spending money. "I was blown away by how much we were spending in some categories, especially overtime," says McCauley. "Our overtime policy was extremely generous, and it was costing us a lot of money."

Wiggle room

Armed with your data, you're ready to create your budget. Start by separating your fixed and variable expenses. Fixed items would include any lease agreements, debt obligations, insurance, and other such expenses you can't avoid but are at least predictable. Typical variable expenses would be for personnel, marketing, raw materials, and transportation, with personnel usually being the biggest. Take into account all the auxiliary aspects of an expense as well: The cost of hiring an employee is not just his or her hourly rate—you have to budget for workers' compensation, payroll taxes, and benefits. Ultimately you'll also want to get an industry comparison from a trade association or local CEO group, to see how the amounts you're spending compare to benchmarks in your industry.

Then look at your top line. Your customers generally will be the best source of information for building an accurate sales projection. What are they expecting for the upcoming year? Are they looking to cut back or grow, and in what areas? "It's a grassroots and effective way to build a sales projection," says Gina Chironis, president of Venn CPA in Irvine, Calif. Again, industry data can help.

How you examine sales, though, will depend on how your business is structured—do you want to go client by client? Or are you better equipped to study the sales histories of individual products? And remember that past sales figures—perhaps based on a booming economy—won't necessarily give the most accurate picture of what the next year might hold.

You also need to build in some wiggle room to provide a buffer against unforeseen events, such as fluctuating commodities prices or a big customer bankruptcy. Although there's no

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magic solution, estimate conservatively, and create an average price you can use throughout the year for line items, such as an ever-changing gas price. A 10% to 20% cushion in your budget is typical, though in a recession perhaps a 25% to 33% cushion may be more realistic, says Raffaele Mari, a CPA in Newport Coast, Calif.

Finally, reconcile your costs and expenses. What is the relationship between specific expenses, such as an additional salesperson or marketing effort, and your top line? Developing such metrics can help you figure out where to cut if unnecessary. At the very least, keep a two- to three-month cash reserve to cover expenses in case money is slow to come in.

Be flexible

Now that you've labored over this document, be willing to change it. "You should always be willing to make changes based on unforeseen circumstances," says Chironis. "That's why it's so important to have a budget, so you can look at what your actual numbers are and see if you are achieving your goals or not, and be flexible enough to cut costs where you can in order to meet your objectives. Business stability is not necessarily in the budget but in how you respond to reality."

To that end, you need to monitor the numbers at least monthly, as does Diane Palumbo, founding partner of 50-employee, $6 million law firm Palumbo Bergstrom in Irvine, Calif. "The start of any downfall is when you don't pay attention to the budget," says Palumbo. "Your budget is your bible. We can't always project what our long-term revenues are going to be, but it's important to look at it and know what is going on over a short-term basis." Palumbo doesn't necessarily adjust her entire annual budget when making changes, unless "there is a catastrophic change, like losing our biggest clients," she says. She does, however, create mini-revisions, changing spending quarterly to make sure she meets annual goals.

Others create several budgets, for best- and worst-case scenarios, and even scenarios in between. When the economy turned south in 2008, Milburn developed three budgets for his design firm in anticipation of the real estate market coming to a standstill—a standard budget, a Plan B budget, and an "absolute crisis" budget that consists of little more than real estate costs and insurance fees. "That final budget is just about survival," says Milburn. The company did fall back on that for a time at the end of 2008, but it has since moved forward into a "happy medium" budget, in which Milburn has trimmed such costs as memberships to some networking groups but is still investing in growth and marketing.

Increasingly, that "happy medium" budget is becoming the company standard. "This process has really helped show us we can operate leaner than we were before," Milburn says. "We've increased our margins to about 15% to 17% from around 10% and been able to give greater value to our clients."

Apex also keeps a Plan B and a Plan C budget at the ready in case revenue drops below a certain threshold. "We have already identified the costs that can be eliminated," says McCauley. In the first quarter of 2009, when business slowed, Apex did resort to Plan B and laid off several people. Plan C, McCauley says, is very bare-bones, "but fortunately we haven't had to go there." Between hiring a new controller, dissecting the books, and laying people off, "It has been a really stressful and unpleasant process," says McCauley. But, she says, making a budget "has really focused us and helped us leverage our people and technology to get the greatest return. Now we're properly positioned for another growth spurt."

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