

Budgeting - What's Next?

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As the sole owner of a second generation wholesaling company in Connecticut, I have spent the past several years growing the business. Much of my time is focused on organizing and managing finances and expanding our sales and marketing efforts. My question is this. On the finance side of the business, I have a very good idea of the cost of goods sold percentage. There is a budget for overhead and marketing expenses, and a forecast for income which I review and adjust semi annually. Each year we seem to just about break even on the bottom line. What would you suggest I work on next?

Congratulations to you, for your hard work and diligent effort in finance. You have tackled what some owners find to be the hardest parts – estimating cost of goods sold, budgeting expenses and forecasting income. The information you have gained working on each of these elements will serve you well as you go forward. Now it is time to take hold of the business and make it work to your advantage.

The first thing you want to do is build an overall picture of the business, financially, including what typically shows up on the P&L and incorporating the balance sheet effects. You want to budget for reserves – which I happen to know this business needs more of. You want to budget for capital expenses and

profit. What you are going to do is use your enhanced budget to design a picture of the business you want to have.

Let's clarify what our reader just described, starting with cost of good sold, which is an important number to know, especially in a wholesale business. Cost of Goods Sold (COGS) is the amount of money this company pays to acquire or produce the items it then sells to customers. By dividing the COGS by the revenue brought in, our owner can calculate the % of cost of goods sold. In this company, like most companies, COGS varies by product. This company's COGS average is 60%.

Another way to think about COGS is, for every dollar this owner's company brings in, in sales, 60 cents went towards acquiring or producing those items the company has just sold, including shipping and handling. Some companies include sales commissions in their COGS calculation as well. The remaining 40 cents, or 40%, is called Gross Profit (GP). GP is what's left over, to run the day to day operations of the company, to fund capital equipment purchases and marketing initiatives, to build reserves and to return a profit.

Now the owner has to decide how to divide up that remaining 40%, which will vary in actual dollar amount. The dollars available to cover overhead, office salaries

and marketing costs, will depend on how much sales volume they expect to have this year. Overhead expenses, typically, are pretty steady from month to month, covering such costs as rent, utilities, phones, office supplies, office salaries and benefits. Since this company's payroll is paid out every 2 weeks, they have to remember to budget an extra payroll every 6 months. Most companies get hit with those extra 2 payrolls in May and November, this year. The other major cost, besides Overhead and Cost of Goods Sold, is for marketing initiatives, which may swing up and down depending on how sales is doing.

Our reader says he has a good handle on overhead expenses, which he has laid out in a monthly budget. And he has a marketing budget, also laid out by month. What he is missing are four other targets, for profit, capital equipment purchases, reserves and paying down debt. Let's take a look at each of these targets.

Profit

Like many business owners, our reader felt that profit was the leftover, after everything else is paid for. That is certainly how it appears on the P&L, since net profit comes at the end of the statement, after income and expenses are subtracted from each other. However, in order to make money, a business owner has to switch the direction in which he or she reads the P&L,

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starting at the bottom, with net profit, and working up from there.

Defining a profit target upfront begins to change how you look at income and expenses. If the goal is to make profit, setting a profit target at the beginning of a period will help you to look at the combination of income and expenses as subject to change, in order to achieve your profit target. If you start with profit, add in Overhead and Cost of Goods Sold expenses, you've just defined how much income you have to have in order to hit your target. If you start with net profit, and subtract that from Gross Income, you've just defined how much money you have to spend, at a maximum, for Cost of Goods Sold and Overhead expenses.

One mistake many business owners make when considering net profit, is that it is a good idea to avoid taxes by spending all of the revenue they bring in, in order to achieve a target of zero net profit. This is backwards thinking. While it is important to work on minimizing the taxes your company, and you as owner, pay each year, it is also important to make a profit. Without making a profit, you won't have any money to put into reserves, to set aside for major capital purchases, or to pay off debt you accumulated in a previous period when you didn't make enough profit. My advice to my clients is, get good tax advice from a qualified accounting firm, to help you deduct legitimate

expenses and minimize your tax bill. Also plan to make enough profit to pay your taxes and still have a lot left over.

Assuming you plan to have money left over, as profit, you want to define what that money will be used for. The typical categories are capital equipment purchases, reserves and paying down debt. Capital equipment purchases are usually defined in manufacturing companies, as major equipment investments, which will be depreciated over time, and which are likely to be financed over time, to minimize a one-time drain on cash flow. In a service company, you might want to consider capital equipment purchases as any significant outlay, including personnel and services as well as equipment. For example, if you need to upgrade your computer software systems, you might want to classify that as a capital expense.

For practical purposes, I like to emphasize minimizing one-time drains on cash flow, as part of the decision on whether to classify something as a capital expense. By this definition, you are looking at major investments in the business, over long periods of time – several years – that improve the business' ability to function. You want to match the expense to the contribution, even though you will probably have to incur the expense upfront. You do this by financing the purchase over time, and spreading the

cost, to match profit increases that are likely to result from the investment.

Now, let's talk about reserves, or the money you set aside each year, as a cushion to help you grow and protect the business. Most companies don't have enough, and don't focus enough on building reserves. Part of the problem in small business, especially with S-Corps, is the profits are distributed at the end of the year, the owner deposits the profits in a personal account, and eventually forgets to keep a portion of the profits available for business use later on.

My suggestion is that you set aside a separate account, in which you deposit a portion of each year's profits, and earmark that account for business use only. In times of need, you can lend that money back to the business, and instead of paying the bank interest to borrow funds, your company can pay you interest on the funds it borrows from you, the owner. Generally, I suggest that business owners strive, over time, to have 3 – 6 months of operating expenses on reserve. With that kind of money set aside, you can weather just about any storm.

Lastly, let's talk about paying down debt. Many businesses get into trouble early on, by thinking that ability to borrow funds is an asset. They think that a line of credit is an opportunity, rather

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than a liability. Remember, any funds you borrow must be paid back, in a higher amount, due to interest. That means that you have to make more, just to break even. So, if you do plan to borrow, make sure it is to support sales or marketing efforts, which will lead to the growth you will need, in order to pay back your debts.

Now, let's get back to budgeting. One of the problems with using the Profit & Loss Statement as a budget, is that not all of your spending shows up on the P&L. Many owners look at their P&L, see a net profit, but don't see the funds in their bank accounts growing. They wonder what's happening. Other owners see the business breaking even on the P&L, or even losing money. These owners are probably closing cash shortfalls with credit lines, credit cards or other debt instruments, or increases in accounts payable, all of which are growing on the balance sheet, not on the P&L. If you are like most business owners, you probably have some debt, which you are paying off over time, as funds are available. Unfortunately, the debt obligation sits on your balance sheet, and the bill you pay to reduce that debt doesn't show up in a standard P&L.

My suggestion is to build an enhanced P&L budget, which reflects your balance sheet obligations. In the budget, under "Other Expenses", budget

amounts for paying down debt, building reserves, setting aside money for capital equipment purchases. While your actual transactions will show up on the balance sheet, or will be moved to the balance sheet by journal entries your accountant makes at year end, you will still have a better picture, throughout the year, to remind you of how you planned to spend your money, and how much you need to make to truly break even, given all of your plans.

Keep up the good work, as you perfect your skills at planning, predicting, and controlling your business' growth. Budget is your ultimate control and profit maximization tool. You are well on your way to success, keep going!

Looking for a good book? Try Budgeting and Finance by Peter Engel, published by McGraw Hill.

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