Creating a Realistic Budget
What will we be covering?

- Why does this matter?
- Financial literacy
  - Common terms
- How to create a budget
- Don’t be afraid of numbers
- Standard financial worksheets
  - CD of sample Excel spreadsheets
Cost of Goods Sold (COGS)

- **What did it cost you to make the widget?**
  - Raw materials
  - Utilities
  - Labor
  - Testing (if applicable)
  - Garment tags

- **These costs have to be directly towards the production of a particular item.**
Common Terms: Debt

- **Borrowed funds**
  - Requires repayment of principal plus interest
  - Can be either short-term or long-term

- **Short-term**
  - Credit cards (be cautious!)
  - Lines of credit
  - Loan from owner

- **Long-term (> 1 year)**
  - Bank notes
  - Leases
  - Mortgages
Common Terms: Equity

- Stake of ownership in the company
- The company’s net worth
- Equity financing
  - Personal savings
  - Friends and family
  - Angels
  - Venture capitalists
  - Partners
  - Retained earnings
Common Terms: Expenses

• **Expenses**
  – **Fixed**
    • Regular expenses that don’t change with volume of sales
    • Examples include rent, insurance, office supplies, office wages, etc.
  – **Variable**
    • Directly related to volume
    • Examples include inventory used, direct labor, electricity, gas, shipping, etc.
Common Terms: Accounts Receivable

- **Source of credit:** you are “the bank”
- **Income usually resulting from sales but not received as cash at time of sale**
- **Generally these sales are credit accounts**
- **Some accounts will not be collected due to various reasons**
- **Be sure customers have good credit scores before extending them credit**
- **Customers may not pay on time**
Common Terms: Accounts Payable

- **Source of credit**: supplier is “the bank”
- **Liability or something that is paid to someone else**
- **Short-term obligations to suppliers**
- **Try to maximize any discounts to increase your cash**
  - Early payments
  - Cash versus credit discounts
Common Terms: Contribution Margin

- Contribution Margin ≈ Gross Profit
- How much is left of a sale to contribute to fixed cost coverage
  sale – variable cost
- Stated as a percent
- EBIT & EBITDA
Common Terms: Projections

• **Pro forma**
  – *Projections for future periods based on forecasts*
  – *Typically projected for 2 to 3 years*
  – *Ideally based on historical financial information*
  – “blue sky” the further you go out
Common Terms: Cash Flow

• How money flows in and out of a business
  – “In” refers to money coming into an organization
  – “Out” refers to expenses or money being paid out

• Concentrated on three main activities:
  – Operating
  – Investing
  – Financing
The “Big Three” of cash management are:
– Accounts receivable
– Accounts payable
– Inventory
Financial Statements

- **Why do I need them?**
  - Outside investors
  - Helps you see the financial “big picture”
  - Score card to track how you are doing

- **Historical**
  - Shows how the company has performed

- **Projected (pro forma)**
  - Basis for diagnosing:
    - problems
    - financing opportunities
    - process improvement
  - Must be as realistic as possible
Income Statement

• Also known as a Profit & Loss statement
• Shows a company’s sales and costs
• Simple formula: 
  \[ \text{revenues} - \text{expenses} = P \text{ or } L \]
• Goal is to have revenues exceed all operating costs to show a profit
Balance Sheet

- Often an overlooked statement
- Shows what you have and how you paid for it
- Snapshot in time
- Has to balance:
  - Company’s total assets always equals or balances the liabilities plus stockholder’s equity
- \( \text{assets} = \text{liabilities} + \text{owner’s equity} \)
Cash Flow

- *Cash is King!*
- *Very important to analyze a company’s cash flow*
- *Many businesses fail due to poor cash flow*
- *Even if your company is profitable, it can suffer from insufficient cash flow*
- *If more money is routinely going out then is coming in, you have a problem*
Statement of Cash Flow

- Another often overlooked statement
- Shows how a business is moving in “real time”
- Revenue and expense structure
- When does the event occur?
- Statement of liquidity
- What do these things tell you?
Inventory & Cash Flow

• **How does inventory affect cash flow?**
  – It’s expensive!
  – Can affect your profitability
  – Additional costs involved in excess inventory

• **What can I do to improve cash flow?**
  – Keep inventory to a minimum
  – Monitor current customer trends
  – Make sure you are receiving payments from customers as quick as possible
  – Make sure you are paying your bills as late as possible
Break-Even Analysis

- Tool used to see at what volume you will become profitable
- Break-even formula: \( BE = \frac{FC}{\text{contribution margin}} = \frac{VC}{I} \)
Break-Even Analysis

- **Does have limitations**
  - *Ignores the importance of cash flow*
  - *Accuracy of information is crucial*
  - *Calculation assumes:*
    - *Fixed expenses remain constant for all levels of sales volume*
    - *Variable costs and sales changes are consistent with one another*
    - *The unit price will remain the same despite an increase in the volume of sales*
  - *Key is to know the denominator when figuring out the formula!*
Creating a Budget
Why Do I Need One?

- Guides anticipated income and expenses
- Compare your goals with actual numbers
  - How is your business performing year-to-year?
- Helps indicate how your business is doing
- Allows you to plan ahead
- You choose the frequency
  - Monthly
  - Quarterly
  - Annually
- Allows you to compare actual numbers with forecasts
- Loans – banks or financial organizations will ask
SBA Says:

• **Budgets help indicate:**
  – The funds needed for labor and/or materials.
  – Total start-up costs (for a new business).
  – Your costs of operations.
  – The revenues necessary to support the business.
  – A realistic estimate of expected profits.
Known Facts

• Start with what you know
  – Historical data
  – Industry data
  – Competitor information
  – Anticipated sales
  – Expenditures

• Best “guesstimates”
  – Move on to what you think

• Analyze, Review and Adjust

• Budgets should never be static
  – They need to be updated and analyzed
  – If you were off on your estimates, why were you?
Conclusion

- Numbers can become your friend
- They tell a story in a way that other information can’t
- Don’t become frustrated, take the time to learn
- Seek out help if you need it
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