

# ZIONS BANK<sup>®</sup> BUSINESS BUILDER 5

HOW TO PREPARE A CASH BUDGET



## how to prepare a cash budget

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At its most basic level, a budget is a plan for owners and managers to achieve their goals for the company during a specific time period. In this business builder you will learn the fundamental concepts of cash budgets and how to evaluate your budget on a month-to-month basis.

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## what to expect

This Business Builder will introduce you to the fundamental concepts of cash budgets and outline the steps necessary for preparing a cash budget for your business. It will also show you how to evaluate your budget on a month-to-month basis. This Business Builder assumes that an income statement and a balance sheet have been prepared for your business. Information from these financial statements are an integral part of creating a budget. Without that information, this Business Builder may not be as helpful as it could be.

## what you should know before getting started

### The Purpose of a Cash Budget

At its most basic level, a budget is a plan. It is a plan for owners and managers to achieve their goals for the company during a specific time period.

The preparation of a cash budget is an important management task. While some small businesses may be able to survive for a time without budgeting, savvy business owners will realize its importance. A cash budget can protect a company from being unprepared for seasonal fluctuations in cash flow or prepare a company to take advantage of unexpected quantity discounts from suppliers.

While there are other types of budgets that can be prepared, such as projected or pro forma financial statements, a cash budget is a management plan for the most important factor of a company's viability— its cash position. A company's cash position determines how suppliers will be paid, how a banker will respond to a loan request, how fast a company can grow, as well as directly influencing dividends, increases to owner's equity, and profitability.

*A cash budget is a management plan for the most important factor of a company's viability— its cash position.*

Many small businesses find it helpful to prepare monthly cash budgets and to analyze any variances between the budgeted and actual amounts on a monthly basis. This enables small business owners and managers to stay on top of any unexpected cash uses.

The creation of a cash budget requires you to make estimates (or best guesses) about many different aspects of your company and the environment in which it operates. Future sales will be contingent on many things, such as competition, the local economic climate, and your own internal operations and capacity. In addition, after sales are estimated, potential costs must also be derived. The important thing to keep in mind while arriving at these figures is that past experience is important, but so is intuition. The estimates you will need to develop must be based in reality and yet contain a dose of creativity and, if warranted, optimism.

There are budgets, other than the cash budget, that are important for your company. However, the cash budget is a good first step if you are new to budgeting.

A cash budget cannot be created in a vacuum. Before and during the budgeting process, business owners must consult with line managers, suppliers, and key personnel to make the best guess possible about the relationship between the goals for the period and their effect on cash receipts and cash expenditures.

## Why Prepare a Cash Budget?

A cash budget is important for a variety of reasons. For one, it allows you to make management decisions regarding your cash position (or cash reserve). Without the type of monitoring imposed by the budgeting process, you may be unaware of the cash flow through your business. At the end of a year or a business cycle, a series of monthly cash budgets will show you just how much cash is coming into your company and the way it is being used. Seasonal fluctuations will be made clear.

A cash budget also allows you to evaluate and plan for your capital needs. The cash budget will help you assess whether there are periods during your operations cycle when you might need short-term borrowing. It will also help you assess any long-term borrowing needs. Basically, a cash budget is a planning tool for management decisions.

## how to create a cash budget

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There are three main components necessary for creating a cash budget.

- Time period
- Desired cash position
- Estimated sales and expenses

Here is an example of a cash budget for a small business:

## Small Business Cash Budget

For the three months ending March 31, 200X

	January	February	March
<b>Beginning Cash Balance</b>	\$15,000	-\$13,500	\$20,000
<b>Expected Cash Receipts:</b>			
Cash sales	20,000	25,000	30,000
Collection of accounts receivable	45,000	55,000	70,000
Other income	0	0	5,000
<b>Total Cash</b>	<b>\$80,000</b>	<b>\$66,500</b>	<b>\$125,000</b>
<b>Expected Cash Payments:</b>			
Raw materials (or inventory)	50,000	11,000	5,000
Payroll	10,400	10,400	10,400
Other direct expenses	2,000	2,000	2,000
Advertising	10,000	0	0
Selling expenses	6,000	8,000	6,000
Administrative expenses	4,500	4,500	4,500
Plant and equipment expenditures	10,000	10,000	10,000
Other payments	600	600	600
<b>Total Cash Expenses</b>	<b>\$93,500</b>	<b>\$46,500</b>	<b>\$38,500</b>
<b>Ending Cash Balance</b>	<b>-\$13,500*</b>	<b>\$20,000*</b>	<b>\$86,500</b>

\*The ending cash balance becomes the beginning cash balance for the next period.

## Time Period

The first decision to make when preparing a cash budget is to decide the period of time for which your budget will apply.

That is, are you preparing a budget for the next three months, six months, twelve months or some other period? In this Business Builder, we will be preparing a three-month budget. However, the instructions given are applicable to any time period you might select.

## Cash Position

The amount of cash you wish to keep on hand will depend on the nature of your business, the predictability of accounts receivable, and the probability of fast-happening opportunities (or unfortunate occurrences) that may require you to have a significant reserve of cash.

You may want to consider your cash reserve in terms of a certain number of days' sales. Your budgeting process will help you to determine if, at the end of the period, you have an adequate cash reserve.

## Estimated Sales and Expenses

The fundamental concept of a cash budget is estimating all future cash receipts and cash expenditures that will take place during the time period. The most important estimate you will make, however, is an estimate of sales. Once this is decided, the rest of the cash budget can fall into place.

For example, if an increase in sales of 10 percent is desired and expected, various other accounts must be adjusted in your budget. Raw materials, inventory and the costs of goods sold must be revised to reflect the increase in sales. In addition, you must ask yourself if any additions need to be made to selling or general and administrative expenses, or can the increased sales be handled by current excess capacity. Also, how will the increase in sales affect payroll and overtime expenditures?

Instead of increasing every expense item by 10 percent, serious consideration needs to be given to certain economies of scale that might develop. In other words, perhaps, a supplier offers a discount if you increase the quantities in which you buy a certain item; or, perhaps, the increase in sales can be easily accommodated by the current sales force. All of these types of considerations must be taken into account before you start budgeting. Each type of expense (as shown on your income statement) must be evaluated for its potential to increase or decrease. Your estimates should be based on your experience running your business and on your goals for your business over the time frame for which the budget is being created.

*Your estimates should be based on your experience running your business and on your goals for your business over the time frame for which the budget is being created.*

At a minimum, the following categories of expected cash receipts and expected cash payments should be considered:

- Expected Cash Receipts:
  - Cash balance
  - Cash sales
  - Collections of accounts receivable
  - Other income
- Expected Cash Expenses:
  - Raw material (inventory)
  - Payroll
- Other Direct Expenses:
  - Advertising
  - Selling expenses
  - Administrative expense
  - Plant and equipment expenditures
  - Other payments

### **Expected Cash Receipts:**

- **Cash balance** - The cash balance is your cash on hand. This includes what is in your checking accounts, savings accounts, petty cash and any other cash accounts that you might have.
- **Cash sales** - After arriving at a base figure of cash sales, it must be adjusted for any trade or other discounts and for possible returns. As stated previously, the base level of sales (and of accounts receivable) will be determined by the company's projections, goals and past experience.
- **Collections of accounts receivable** - After a base level of accounts receivable is established (based on sales projections), it must be adjusted to reflect the amount that will actually be paid during the time period. Typical adjustments for a small business might be to assume that 90 percent of accounts receivable will be collected in the quarter in which the sales occur, nine percent will be collected in the following quarter, and one percent will remain uncollectible. Of course, past experience will be the most reliable indicator for making these adjustments.
- **Other income** - Your cash position may be affected positively by income other than sales. Perhaps there are investments, dividends, or a loan that will be introducing cash to the company during the time period. These types of cash sources are referred to as "other income."

**Expected Cash Expenses:**

- **Raw materials (inventory)** - For small business retailers and manufacturers, the largest cash expense is usually the amount spent for inventory or raw materials. Again, past experience will be your best indicator of future cash outlays. But don't forget to factor in any necessary increases to keep up with projected sales. You may also want to consult with your suppliers as to whether any pricing changes are expected.
- **Payroll** - Salaries are commonly the second largest expense item during an accounting period. Don't forget to include estimates for all appropriate local, state, and federal taxes.

**Other Direct Expenses:**

Use this line item for any additional expense that does not fit conveniently under the other headings. If you are making payments on a loan, include it here.

- **Advertising** - The role of advertising varies by type of business. If you are projecting an increase in sales, is there an accompanying marketing or advertising campaign? These costs must be budgeted. Include any expenses for print (brochures, mailers, and newspaper ads), radio, or other advertising services.
- **Selling expenses** - Typical selling expenses include salaries and commissions for sales personnel and sales office expenses. However, this line item can also include any traveling or other sales-related expense not covered elsewhere.
- **Administrative expenses** - General office expenses are included here. This will include your utilities, telephone, copying and day-to-day office expenses. Unless big changes are underway, past experience will guide you in evaluating future administrative expenses.
- **Plant and equipment** - Cash payments for equipment loans, mortgages, repairs, or other upkeep should be included here. Past experience will, again, be your guide.
- **Other payments** - If there are any cash payments you expect to make that are not covered in the above listing, include them here. (If they are repeatable, you may consider adding a separate line item.) However, typically, interest payments and taxes fall here.

Step 1: Create a cash flow budget for your company for a three-month period.

Here is a cash flow budget worksheet for a small business:

	January	February	March	Totals
<b>Beginning Cash Balance</b>				
<b>Cash Inflows (Income):</b>				
Accts. Rec. Collections				
Loan Proceeds				
Sales & Receipts				
Other:				
<b>Total Cash Inflows</b>				
<b>Available Cash Balance</b>				
<b>Cash Outflows (Expenses):</b>				
Advertising				
Bank Service Charges				
Credit Card Fees				
Delivery				
Health Insurance				
Insurance				
Interest				
Inventory Purchases				
Miscellaneous				
Office				
Payroll				
Payroll Taxes				
Professional Fees				
Rent or Lease				
Subscriptions & Dues				
Supplies				
Taxes & Licenses				
Utilities & Telephone				
Other:				
<b>Subtotal</b>				
<b>Other Cash Outflows:</b>				
Capital Purchases				
Loan Principal				
Owner's Draw				
Other:				
<b>Subtotal</b>				
<b>Total Cash Outflows</b>				
<b>Ending Cash Balance</b>				

## how to analyze a cash budget

The preparation of a cash budget is only the first step toward good financial management. The next step is to analyze to see how close the company is performing to expectations. Have any unexpected cash outflows occurred? If so, is the company's financial position seriously affected?

A simple method for monitoring the cash budget is to prepare a budget versus actual report of actual and budgeted expenses every month. This type of report consists of four columns. The first column shows the budgeted amounts, the second column shows actual company performance, and the third and fourth columns show the difference in terms of dollars and percent.

Step 2: If the data is available, construct a budget versus actual report for your business.

**Below is a sample month-end budget versus actual report for the fictional Turtle Company:**

### Budget vs. Actual Report

	Budget	Actual	% Variance
<b>Cash Balance</b>	\$5,000	\$5,000	0%
<b>Cash Receipts:</b>			
Cash sales	20,000	22,000	110%
Collection of accounts receivable	15,000	13,500	90%
Other income	0	0	0%
<b>Total Cash</b>	<b>\$40,000</b>	<b>\$40,500</b>	<b>101%</b>
<b>Expected Cash Payments:</b>			
Raw materials (or inventory)	15,000	15,000	0%
Payroll	7,200	9,400	130%
Other direct expenses	500	500	0%
Advertising	500	1,000	200%
Selling expense	1,500	1,400	93%
Administrative expense	500	500	0%
Plant and equipment expenditures	5,000	7,500	150%
Other payments	0	0	0%
Total cash expenses	30,200	35,300	116%
<b>Ending Cash Balance</b>	<b>\$9,800</b>	<b>\$5,200</b>	<b>53%</b>

As you can see, cash expenses for payroll, advertising and plant and equipment exceeded the budgeted amounts for the Turtle Company. And because the company analyzes these figures monthly, changes can be made before the increased expenses become unmanageable. The use of a budget versus actual report allows owners to pinpoint how actual cash inflows and outflows vary from expectations and to make adjustments.

## conclusion

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This Business Builder focuses on the creation of a cash budget for your business. While there are several other types of budgets that can be prepared, small business owners should pay close attention to their cash position and create a cash budget for their company. Preparing a monthly budget versus actual report will give small business owners the information they need to make important decisions about the cash position of their company.

## checklist

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- When preparing your cash budget, did you remember to make the ending cash balance the beginning cash balance for the next period?
- When estimating cash expenses, did you remember to factor any additional material, labor or other expenses for projected sales?
- Is your sales goal for the period realistic?
- Did you remember to adjust accounts receivable for possible uncollectible amounts?
- Do expenditures for payroll include taxes?

## resources

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### Books

**Financial Decision-making: A CPA/Attorney's Perspective** by David L. Fraley (PSI Research/Oasis Press, 1998).

**Fundamentals of Financial Management, 11th ed.** by James C. Van Horne and John Martin Wachowicz (Prentice Hall, 2001).

**Handbook of Budgeting, 4th ed.** by Robert Rachlin (Wiley, 2000).

**Handbook of Financial Analysis for Corporate Managers** Revised ed. by Vincent Muro (AMACOM, 1998).

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