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8 Things to Consider When Planning Your Business Budget

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As we showed in part 1 of this discussion (https://eiexchange.com/content/is-self-interest-complicating-your-budget-planning-process) , trying to use budgets as both a planning tool and an expectations setting tool can be destructive, because the self-interests of different factions within the business can skew the planning process. This article outlines a process for creating a realistic budget that can be used as a planning tool, while also accommodating the owners' tolerance for risk.

The first step is to establish a likely range that a given budgeted number will fall in. Do we want to plan for 100% (very conservative) probability or perhaps a more aggressive 80% number? A 100% number might be sales of $100 million, whereas an 80% number would be higher, more like $120 million. This choice to be conservative or aggressive is based on the level of risk we are willing to live within. The 100% budget is the base and should be set based on the business' characteristics (growth rate given the capacity to respond and the market characteristics, working capital needs for every new dollar of revenue, readily available materials vs. long lead times, high vs. low fixed costs, and so forth).

Some circumstances make aggressive budgeting more or less risky. If the business generates cash -- for example by being paid in at the time of sale, high turnover of inventory (like food), and a long period in which to pay vendors -- then the risk of running out of cash from an aggressive budget might be small. Generally, if lead times to buy materials are short and costs are stable, and adding capacity doesn't cost much, aggressive budgeting is less risky. Again, the idea here is to set a number that balances what we can do, particularly with regards to net sales, with what would happen if we don't do it and what would happen if we exceeded the number by too much.

Most businesses that have broken free of their sales group setting revenue budgets traditionally **set forecasts** with 100% certainty, which can create unrealistic expectations. For many businesses, a better approach might be to establish forecasts at a 90% certainty level (higher sales than 100%). This ensures realistic expectations and portrays the company as successful without downplaying achievements. What is more, this approach helps them manage cash effectively.

Factors to Consider

A more fine-grained approach to setting revenue budgets is to consider different business and market characteristics. Here are eight considerations to guide business owners, their boards, and their senior leadership teams in thinking through the consequences of setting aggressive versus conservative budgets. The recommendations below should not be used without a lot of thought for your business' specific situation.

Growth Stage

Ideally, budgets are tailored to the business's growth stage. Growth units perhaps should budget at an aggressive 70% probability of achievable revenue, thus promoting investment. Meanwhile, cash cows can aim for sales at an 90% or more probability, minimizing unnecessary expenses and investments.

Availability of inputs

In terms of setting inventory levels, for which there is an amazing science worth consulting, leadership should tailor the approach based on the nature of the purchase. For items that can be inventoried without degradation, set budgets at the 75% certainty level. For items with long lead times, a 60% certainty level might be more appropriate. Easy-to-get items with readily available inventories should be budgeted at 25% under the 100% certainty number, especially when inflation is not anticipated.

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Labor availability

Labor can be a major constraint on growth. And like other inputs, we shouldn't be having too aggressive a sales budget if we cannot find labor to support it. If labor is tight, and we are at or close to capacity (meaning labor would have to be added for expanding sales), then we should be budgeting closer to the 100% number.

Capacity constraints

Particularly if adding capacity is very expensive and/ or will take a lot of time, when we are close to capacity we should budget closer to the conservative 100% number. At the same time, leadership should consider the mix of customers and products/services to increase profitability when capacity constrained.

Cash availability

Having lots of cash can be a double-edged sword. Of course, having lots of available cash is a welcome cushion in times of distress. However, it takes a superior and highly principled leader to stay disciplined when that kind of safety net is easily available. Furthermore, cash on the balance sheet that is not earning the same return as other assets increases the denominator of the Return on Equity (ROE) equation and lowers ROE, which may become a bone of contention with shareholders who are not employed by the business. Generally, it is better to have very slim cash reserves and engaged and supportive shareholders who are willing to invest in the company when new investment is needed. Companies with small cash reserves should budget close to the 100% percent number, perhaps getting as aggressive as 90%. That way the company can make sure cash is available without missing too many opportunities. This is particularly the case for a company where its cash cycle is such that it has a hard time if generating cash.

Level of debt

When a company has a high level of debt it often runs the risk of breaching one or more of its banking covenants (the financial ratios it needs to maintain to protect its credit with and not get in trouble with the banks). In such a situation, it is paramount that the company has precise cash projections. Without them, the company and shareholders risk having an overly optimistic leader who convinces themselves of “selling” their way out of the problem. While a nice thought, that rarely happens in practice and it also does not usually consider that every new sale takes cash to generate. As I like to say, a good strategy is one where about seven things can go wrong and it will still succeed; whereas a bad strategy is one where at least seven things need to go right or it fails. To make sure a company does not breach its covenants in the case of a high level of indebtedness, it would again be wise to budget close to the 100% number and preferable a slightly aggressive 90% number. With that said, it is important the leaders have the discipline to be transparent with their lenders and seek approval for or turn away sales if they would lead to covenant breach.

Competitor aggressiveness

Reactions to aggressive competitors can shrink margins if you are trying to maintain or grow market share. Aggressive competitors usually compete via price, service, features, or advertising, and promotion. That means either spending more or charging less to compete at an equal or more aggressive level. So, if you budget sales based on past years in a year in which you know your competition is becoming more aggressive, you will possibly have cash flow issues and maybe profitability issues as well. In such cases, it might be wise to budget at the 100% level so you don't overspend, build inventory, build capacity, and so on, in an environment where shrinking might be needed. You can choose to try to hold share or grow it and shrink your resource base, or wait until the carnage is over and potentially have the capital to pick over the bones of your dead or dying competitors.

Selling vs. holding the business

Entrepreneurs who hope to sell their business must consider another group's interests when planning and budgeting for the future: potential buyers. To that end, they may choose to reduce long-term investment, maintenance, and other spending needed to assure long-term survival in favor of showing trends that are attractive to buyers:

- **Increased profits** (less expense, more profit), increasing operating cash flow (EBITDA is often used as a proxy for this, and is increased when profits go up and investment and expenses are reduced)
- **Return on Assets** (this increases when assets go down, which they do as soon as the company stops investing in assets, which reduces asset value on the balance sheet)
- **Return on Equity** (ROE goes up when profit goes up and/or equity goes down, thus favoring

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larger distributions to owners, which reduce equity but are not deducted from profit or operating cash flow).

Entrepreneurs also balance these expense reductions with increased expenses and focus on expanding sales, because few things enhance the price paid for a business as much as showing an increasing profitability trend (like higher Return on Sales - ROS, or profit divided by sales) combined with increasing sales.

As you can see, some of these goals will be at odds with how different employees are incentivized, so business owners may want to take greater control or change incentives to align the with the goal of maximizing the eventual sale price. One way to think about this is that if you have a value for the business before you start preparing for sale, any additional value that requires managerial and other support can be split with others. This can create a healthy incentive to encourage aligned behavior.

Overcoming the Planning – Expectations Divide

I hope it's become clear that setting unrealistic budgets, shaped by the whims of different factions within the company, can have a negative impact. The fallout can include breaking banking covenants, running out of cash, having too much or far too little inventory, having far too many or too few employees, and so on. Taken together, connecting any kind of compensation or personal gain -- even as small as making someone's job easier -- to budgets is a recipe for future problems.

In most cases it's wise to disconnect budgets from incentive compensation. I am not against incentive compensation, but performance can be measured in many other ways without it confounding the budget planning process. This might include using a percentage of residual income as a bonus pool (amount of profit exceeding a reasonable long-term cost of equity target), phantom shares tied to business value for long term incentives, subjectively defined incentives, and so forth. But those will have to wait for another article.

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