A BUDGET IS LIKE A MARRIAGE; YOU HAVE TO WORK ON IT TO MAKE IT WORK

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Abstract

The key concept of this paper is to emphasize the simplicity and major importance of budgeting. It shows that the essence of good budgeting is changing the original budget as times change and that times invariably do change. It indicates that percentages are more useful than the numbers in a budget as these lead to trend analysis, firm understanding and informed discussions with parties interested in the progress of the firm. Finally it shows that the firm's net income or its bottom line is not a lump sum but a fluid number that is mostly used up during the budgeted period. Like a marriage, a budget is always a work in progress

Key words: Budget, percentages of sales, net income, allocation, change

Background

There seems to be a lot of confusion about budgets and, sometimes, even marriage, these days. Both are pretty simple if we realize that, once committed to either or both, it will only work if we adapt to the inevitable changes that occur as time goes by. A budget is not set in concrete. It's the best we can do to predict the future at the time we do it. Likewise, we can't get married and then carry on in the future as we did before. Things change and we need to change with them. A good budget, and marriage, adapts. A poor one does not, even if it seemed pretty good at the start.

Let's look at a budget a little more closely. We cannot predict the future, so our budgets are bound to be wrong; and the further away we predict, usually the worse we'll be. Our real work is to change where we went wrong with as little pain as we can and then explain these changes to those that are affected. Too many private and public officials are unwilling to do this and consequently things get worse. Look at our attempts in both these sectors as we cope with the current recession when the future looked so rosy a few years ago.

What is a budget?

A budget is an essential planning tool. It is an attempt to manage the future. Specifically, it is our best attempt to forecast future revenues and costs for an enterprise, or firm (or government). It is usually done monthly, quarterly or annually, or, preferably, if relevant, all three. The budget indicates whether we think we will have enough money to continue with what we're currently doing and/or expand, reduce or otherwise change our firm. It also indicates how to manage our debt profile. Budgets are used by firm owners, managers and interested debt and equity capital associates to see how the firm might be handling the future. A good budget, like a good marriage, encourages important questions. This paper will concentrate on the firm's budget and generally ignore the enterprise budgets making up the firm.

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What does a firm budget look like?

Table 1 shows a representative monthly, quarterly or annual firm budget and its essential components. It could also represent an individual enterprise budget. The numbers are small, solely for illustration.

Table 1: What a firm budget looks like

Row Names	Dollars ('000)	Percentage
Sales (+)	100	100
Costs (-)	75	75
• Cash		
• Depreciation		
• Overhead		
EBIT (=)	25	25
• Interest	5	5
• Taxes	5	5
Net income (=)	15	15

The row names are the important features .The third column is an individual preference which shows the percentages of each row name with respect to sales. For example, our total costs are budgeted as 75% of sales; or for each $1 of sales, 75 cents go on costs. These percentages are useful to discern trends. So, if the cost percentages have been rising over the last few years, we should either improve cost management, or understand why our sales do not show a commensurate increase.

What does a budget contain?

Each row name in table 1 emphasises the main firm components. The sales are our best guess of what we will receive, say a year from now. A real budget would itemize the sales of each enterprise to show the individual contributions, but these are combined here for simplicity.

Firm costs are divided into three categories. Typically in agriculture, and interestingly enough, in many other industries, cash costs make up around 75% to 80% of total costs, depreciation (calculated from tax allowances) some 15% to 18% and overhead the remainder. Cash costs are the costs we pay cash for. These include feed, fertiliser, chemicals, irrigation, labour, marketing, fuel, repairs, insurance, licences and tools. These are the most productive of our costs and tend to have a marginal productivity >1. Most farms spend at least 80% of their cash costs on no more than five of them. So if cash costs are 80% of total costs on a specific farm firm and four or five of them are 80% of cash costs then these five make up some 60% of total costs. Consequently these dominating cash costs should be the main focus of the firm's cost management and, perhaps, listed individually under cash costs in our budget, while lumping the remaining cash costs together.

Depreciation is what is allowed by the country's tax authority for capital items like machinery, vehicles, buildings, tree crops and breeding stock. Again, we can generalize and still be pretty accurate. Thus, if the depreciation is much lower than 17% of total costs then this may suggest new investment is required. If much higher than 20% of total costs, then we may be over investing in capital items or we are underinvesting in cash costs.

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Overhead is the cost of running the firm's office. This includes office utilities, accountant and lawyer fees, business travel, office depreciation, education for staff and sundry items like stationary. Overhead is the least productive of the three main costs and should not be much more than 8% of total costs. If it is, we need to know why; be aware of a lot of business travel.

Subtracting the total costs from sales gives us the anticipated EBIT, or earnings before interest and taxes. It is a useful "bottom line". If our budget shows it is higher than normal, we may be able to either invest in capital items to reduce taxes, or pay off debt faster, or both. If lower, then we could see our lenders and plan a reduced system of debt payments. Look at EBIT carefully and decide what it indicates for the future of the firm.

The importance of net income

Subtracting the interest and taxes from EBIT gives net income. Net income is the true bottom line of the firm and therefore the most important single number for any firm. It is also called profit or earnings. Because the word "profit" has different meanings for many people, we will stick to "net income".

Table 2: Net Income and it allocation

Row Name	Dollars	Percentage
Net Income	15	100
Wages	6	40
Reinvestment	6	40
Principal	3	20

Tables 1 and 2 show our budgeted net income is $15, or, for every $1 of sales, we anticipate 15 cents of net income. This sounds remarkably good until we realize that we still have to allocate this sum among three other requirements. Table 2 shows the allocation and also shows that net income is used up in this operation. Firstly, it must pay the salaries of the owners. In a small family run firm, this is often regarded as profit, or wages and is spent on household expenses, home improvements, clothing, schooling, medical, retirement funding, vacations, personal transport, entertainment and similar items that pertain directly to the family and not to the firm. So now, for every $1 of sales, we expect 6 cents for our wages, or we allocate 40% of our net income for ourselves These wages are equivalent to dividends paid by corporations to their stockholders and typically these take 40% of net income.

Secondly, net income is used for the firm's retained earnings. Retained earnings are divided into new investment and principal repayment. New investment means buying additional capital items, expanding the firm, for example by purchasing more land, or investing in other things, like buying other firms, or investing in stocks. The 40% allocation of net income shown is also fairly typical. Obviously, if the budget shows a tough time ahead, then there will be little investment made for firm growth. Or if the current investment climate is not good, then any sums accumulated for retained earnings can be held in cash or cash equivalents to wait for better times.

Thirdly, net income must provide the money to pay back principal on debts, the second part of retained earnings. Note that the allocation is 20%, (which is inevitable if the previous two are 40% each) but the point is that if the number is much higher, then we may not have enough money to live

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on or to invest to keep the firm healthy. It is therefore a good indicator for discussion with lenders, as it is usually the only one of the three allocations that we do not have full control of.

Table 2 therefore shows us that our budgeted net income of $15 is not a lump sum waiting for us at the end of the year. Most, if not all of it, will have been dispersed throughout the year. This is because we need money or wages throughout the year to live on. Similarly, principal and interest payments and any new investments are usually made throughout the year rather than at the end. The bottom line is thus a lot more fluid than it might appear.

Look at the net income allocation like this. How much do we think we need to live on over the next year? What firm expansion do we want to make next year? How much have we committed in principal payments over the next 12 months? Quantifying the answers completes the budget. The final task is to review it within the family, other firm owners and interested parties like lenders, farm advisers, input suppliers and our accountant. And like a marriage, we need to think about how we're doing now, where we were before and where we plan to be over the next year.

The two tables provide a skeletal layout of a complete firm budget. Individuals can and certainly should expand this skeleton by increasing the row names, particularly by including the firm's enterprises under sales and perhaps the four or five main cash costs under the cash cost row name. The other cash costs might be lumped together or, if the firm is sufficiently large, also itemized. Realise that one of the best features of a budget is to allow the owner to concentrate on the main items in the firm, rather than coping with hundreds of them. So do not be reluctant to modify the budget layout. Use what is useful for you but ensure inclusiveness. One size does not fit all; it rarely does for most of the financial tools on an agricultural firm.

What happens if things change?

Things always change, in budgets (and in marriages), and it is unlikely that our budget will turn out as we had hoped. This is the most difficult and important part of the budget to understand and to manage. It is probably also the useful part of our budget. Think of taking a detailed shopping list to the grocery store. The list is planned, written down and carried into the store. It is, however, unlikely for many reasons that the shopper will walk away with everything on the list only, in the brands and quantities that were listed.

We similarly cope with changes in our firm budget. We delete some things that are too expensive, unobtainable or can be substituted by a better product, or add some things that we overlooked in the original budget. We change the principal payment schedule by explaining why it is necessary. We sell an enterprise or add one because it makes sound economic sense. All these things are done because we either did not think of them when we did the budget, or changes occurred that required us to change.

Experience suggests that too many firm operators allow the budget to rule them rather than re-write it. For that really is the purpose of the budget. We are always wiser about a set time in the future as that time gets nearer. We need to get into the habit of looking at our budget regularly, as part of our management programme. Doing monthly budgets and therefore reviewing them monthly would automatically provide this review.

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In a nutshell, what we try to do is to predict the future using good, sound commonsense. This provides us with a direction for the firm. As we travel towards this future, the path will almost certainly change, but we still try to go in the right direction. So take courage and walk proudly in the budgeted direction down the road less travelled.

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