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How to create a budget and why you need one in the first place

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Creating a budget is one of, if not the most, critical steps you can take to help ensure your small business maximises its chances of surviving beyond the first few years. Most entrepreneurs like yourself, start with a good idea, an identified market niche and a tremendous amount of enthusiasm to do whatever it takes to make the idea succeed.

But to what end? Having a clear financial goal in mind, which assists in shaping your broader business strategy for the year, also provides a sense of purpose to your company. And a budget, which sets revenue targets, monitors costs and aims to achieve a certain level of profitability, is the key to reaching whatever financial goals you have.

But do you really need a budget? And how do you set about creating one for the first time? To the first question, the answer is simple; every business needs a budget if it's to succeed. If you're not tracking sales, studying your personnel, raw material and other costs, then it's impossible to know where your business stands and how you're going to make it grow or become profitable. Below is a step-by-step guide to help you on the path to budgeting success:

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Before your start

Far from being a glamorous task, sitting down to create a budget for the first time can also be a very daunting prospect. Do you know when your strongest months are in terms of sales throughout the year? Conversely when are your quiet times? If your business has been operating for at least one or two years and you don't have a budget, now is the time to go back over all your monthly sales totals and start working out when the money's coming in and just as importantly, when it's not.

After that you need to determine where each and every single dollar you're spending is going. Breakdown your labour costs (if any), your input costs, office expenses, recurring bills such as utilities, financing costs and all other outgoing expenses that detract from your revenue. Hopefully this leaves you with some cash left over; if so you have your first glimpse at what your profit margin is. But what if you discover that margin is well below what you were aiming for, or worse, it's in the negatives?

This is where having a clear financial goal in mind becomes so important. Regardless of whether you want to turn over \$1 million in revenue, achieve a profit margin of 15%, or take home a \$100,000 a year in salary, you must know what you're shooting for. Far from simply being a recording keeping tool that tracks income and expenses, your budget represents a desired end point (financial goal) and a roadmap for how to get there.

Now that we're armed with this personal financial objective in mind and an accurate list of all incoming revenue and outgoing expenses, it's time to get down to the nitty gritty of creating a budget.

The four key steps to budgeting

1. Step One - What are your costs?

The first step is to separate all fixed costs from all variable costs. Why does this mean? In short, any expenditure that is set in stone because it's a business necessity and is fairly predictable (property leasing, insurance, utility bills, etc), is a fixed cost. Variable costs cover all other expenses, including employee costs, marketing, raw materials and all other changing or optional expenses.

2. Step Two - Predicting your sales

The second step is to try and accurately establish what your monthly and annual sales volume will be over the course of a year. Clearly if your business has been operating for several years, this will be a much easier process. If you don't have that luxury however, talk to your existing and prospective customers. Find out what times they'll most likely be looking to buy your goods or services, in what quantities, and then try to estimate your revenue that way. Obviously this process involves some guesswork so it's important to build in an allowance to account for uncertainties or unpredictable events; even the banks sometimes get this one wrong. A 10-20 percent margin is typically considered safe, though some businesses prefer a slightly larger safety zone during a recession.

3. Step Three - Your budget, line by line

The third and most crucial step is to then work out what the likely impacts are of either reducing or increasing certain expenses, on revenue. If marketing costs are high, but you're not seeing additional customers as a result, now's the time to consider reducing the expense or changing your advertising strategy. Similarly if demand is high, maybe adding an extra salesperson who'll bring in additional sales (that exceeds the cost of hiring them) is an option worth considering.

4. Step Four - Flexibility

Finally, the real secret to any business budget is its (and your) ability to be flexible. This means that having cash reserves or ways to reduce expenses following a particularly rough sales month are ready to go if necessary. If revenue falls below target, you need to know what changes can be made to the budget to help bring it back on track quickly. While an initially well structured budget is the key to achieving your financial goals for the year, the reality is that they require constant tinkering at regular intervals, as revenue and expenses fluctuate.

Having the flexibility, through spare cash and an ability to cut or increase spending as needed, along with a determination to stick to your budget, are the best moves you can make to ensure your company reaches its profit goals, continues to grow even during changing economic conditions, and most importantly remains viable well beyond the current financial year.

Need more information about budgeting? Download an example of a simple and easy to use monthly budget that shows you the core elements your budget will need or read more about strategies for minimising expenses and maximising revenue >>