FOUR TIERED BUDGETING

To understand where you're going, you must first make a map.

Josh Patrick, CFP®

STAGE 2 SOLUTION

HELPING BUSINESS CREATE EXTREME VALUE

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INTRODUCTION

In the work that I've been doing with firms over the last year I've seen a pattern of firms working very hard, but not always achieving what they want. After much thought about this issue, I found that most companies have not made a road map of where they want to go and how they are going to arrive at their destination. This road map is simply called a budget.

I also have found that many companies don't want to budget because they believe the process is too long and not very accurate. We've put together a process that will make everything go much more smoothly for your firm. We call it Four Tiered Budgeting.

If you look at most textbooks on annual strategic plans, you would have to write 40 to 100 pages of information to follow all of the guidelines in these suggested methods. I know that your time is at a premium so if you had to do this amount of detail, you most likely would never get around to putting together these programs. In addition, I want your budget to be a working document that you and your key people use on a monthly basis. The only way this will be done is if the document is short and to the point.

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Enter Four Tiered Budgeting

When you break down the budgeting process, there are only four areas you need to pay attention to. Those areas are a marketing budget, human resource budget, capital budget and operating budget. When you put together your annual road map you should follow the order listed above in your budgeting process.

Make sure you keep the document short. The maximum length should be 6 pages long. Preferably, the report should have one page for each of the budget areas. Remember, the purpose of your budgeting program is to build your roadmap for the coming year. The key people in your organization will most likely not read and use a long document. A short document will allow you to all work on the same page all year long.

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A final note on budgeting is, keep your time line short. I suggest that you only budget one year in advance. In the best of all worlds, you would update the budget on a monthly basis to add a month to the end of your document. This is called a rolling budget. By doing this, you will have to ask yourself and your key people the important questions every month about your corporate assumptions for annual sales, growth and profits.

The Marketing Budget

Peter Drucker says "only marketing and innovation produce profits, all the rests are just costs." With this statement in mind, I think the first thing you do when preparing an annual budget is to start with your marketing budget. This budget should have short statements on the following issues:

- What percent of sales will you do over the next twelve months with your present clients?
- How much business will fall away from your present Clients?
- What is your strategy for bringing new business in to your firm?
- How are you planning to profile Clients so you only work on high quality new business?
- Are the lines of business you are presently in giving you the return you want?
- If the lines of business are not the ones you want, what specifically are you going to do to get better lines of business that your company can service?

From this information, you should be able to put together how much business you will do over the next year and what your gross profit on this business will be. I believe that the marketing budget is the most difficult of all the budgets to prepare. You are making assumptions that may or may not come true including what will happen in the market. It's important to revisit this budget at least quarterly to make sure your assumptions are correct and make adjustments when your assumptions are not.

Your marketing budget is going to be the lead for what you're going to need to do for your firm the rest of the year. Remember, sales drives everything else you plan to do with your company.

The Second Step, Human Resources

After knowing what your projected business flow will be, it's now time to start working on your human resources budget. For this part of the budgeting process you will want to have the following information assembled:

- How many and what type of positions will you need to deliver the services and products you expect to sell.
- What skill sets will you need to provide your services?
- What management talent and technical talent will you need?
- A review of how much you will have to pay each position.
- A review to see if you have the talent and the right people in the righ chair.
- A gap analysis that tells you where you have weaknesses and changes your company will need in either people skills or enhancing skills of the people that you have right now.

After assembling the above list, you will then plot your actions for having the right people in the right position to deliver the service that is in your marketing plan. Too often I see companies where they have a great plan for getting new business, but have not put any effort into support or service operations that will allow them to deliver the service they promise.

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One of the hardest parts of the human resource budgeting process is a review of the people you have on staff. This review must include whether you have the right people in the right spot. As conditions change and your business grows, you will find that you often outgrow the people who have helped you get to where your business is. In order for your company to continue to prosper, you must take the correct actions in either having the people you have in place gain the ability needed or make changes so you have people with the right skills sets in the right place.

The next step is often a sad one. Instead of putting that person back in a position where they are successful, we force them into doing something that is not right for them and often end up having to ask them to leave our company. I suggest using the part of the budgeting process to take a good look at the skills you have in your company and putting the right people in the correct slots.

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Step 3, the Capital Budget

We now know where our business is coming from, the basic costs of delivering this service and the cost for the people to provide the service. We now get to move into our capital budget. This is where we chart how much money we need to spend on fixed overhead items to provide the service we want. This also includes replacement of fixed overhead items that need regular and ongoing replacement. Some of the areas to look at in capital budgets are:

- Do we want to own the new equipment or are we better off renting or leasing the equipment?
- If we need to own the equipment, are we better off having new or is it more effective for us to have used equipment for the project?
- Are we being realistic for the useful life of the equipment we want to use?
- How much of our capital budget should be put towards replacement of equipment that we have in place for our present Customer base?
- Do we need to capitalize recruiting, training and placement for having the right person in the right chair.

This is the part of the budget that requires financial literacy in understanding how cash flow, capital return and return on investment all work together. When putting capital equipment in place we are taking money that could assumedly be invested someplace else for a positive cash flow return. We need to always be looking at alternative investments and see if the money we are about to invest in a capital project is money that is well used.

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The second part of the capital budget that is important is matching after tax cash inflow with after tax outflow for the capital costs. I often see companies where their principle requirements are much higher than their depreciation on their operating statement. For example, they might have a depreciation number of $50,000 per year, but they will have a loan repayment requirement of $75,000 for that year. That means for them to breakeven on a cash basis, the company will have to make $25,000 plus the taxes that have to be paid on the profit, typically 30% or more of the amount due over and above the depreciation number.

If the profits for this firm are not about $35,000 to $40,000 they will start to run out of money. If this behavior continues for several years, the company could become insolvent and forced into bankruptcy even though it's making money. This is where the lease versus buy versus rent decision becomes very important.

The other part of the capital budget that requires high evaluation is when you take on fixed overhead expenses. Variable direct expenses are relatively easy to pare down if you have a business downturn. On the other hand fixed overhead expenses are very difficult to get rid of and usually have a multiyear outflow requirement. An example of this sort of expense would be taking more space and having a long-term lease with the space.

The final step, your operating budget

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After putting together all the individual pieces of a marketing budget, human resource budget and capital budget, you are now in a position to see what the end result might look like. Your operating budget will let you have the basic numbers to see where you should stand at the end of your year. The information you will want to have in an operating budget is:

- Sales, product costs and direct operating costs for the year.
- A breakdown of General Administrative expenses.
- A pro-forma balance sheet showing your expected assets and liabilities at the end of the year.
- A pro-forma cash flow statement showing what the use of your cash will look like at the end of the year.

Putting these statements together will give you an idea whether the assumptions you made in the first three sections of your budgeting process make sense. If the result you get with your operating budget does not meet your expectations, then you must go back and see what sort of **realistic** changes you can make in your budgeting process. Remember, it's important that you clearly outline what your probable expenses and costs will be. If not, then the whole process becomes one that is not worth the paper it's printed on.

I suggest you do your operating budget last because it ties together all the information you have gathered in the first three sections of your budgeting process. It also should help you pinpoint where you have problems if and when they occur.

Conclusion

Your budgeting process is best when short. The more successful you can be at keeping this document short, the more likely you and your staff will be to use the information you put together.

You should share this information with at least all the members of your management team and key players in your firm. You must include these staff members in the appropriate part of the data gathering process as the budget is being put together. If your managers are part of the budgeting process, then there is a much higher probability that they will be supportive of making the numbers come true.

Finally, I suggest that you strongly consider using a rolling budget format. This means that on a monthly basis, you plug in numbers for all the four areas above for the month that you just finished. I like this process more than an annual one because it forces you to continually look at refining your operation and allows you to make adjustments to your thought process during the year. It also will have the natural effect of having you continually improve the quality of your numbers, which is the basis of any good quality control program.

Developing financial literacy and having the discipline to work your budget on an ongoing basis can be among the most important disciplines you can bring to your business. These skills are most important with a gyrating economy where long-term predictability is a thing of the past.

About The Stage 2 Solution:

The Stage 2 Solution is a group who focuses on helping their clients create extreme value in their business. The focus of our help is on Registered Investment Advisory firms that do over $2,000,000 in gross revenue per year.

We help our clients manage revenue, create a memorable reputation and work with owners on strategies that will create sustainable value in their firms as well as for the owners of the firms.

For more information please contact:

Josh Patrick

The Stage 2 Solution
20 Kimball Ave., Suite 201, South Burlington, VT 05403

Jpatrick@stage2solution.com

(802) 846-1264

Visit us on the web at www.stage2solution.com