Veterinary Introduction to Business and Enterprise

Budgets and Forecasts: Cash, the lifeblood of a business

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Budgets and Forecasts

Cash - the lifeblood of a business

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Learning Objectives

Outline the benefits and essential elements of effective budgeting

Explain and prepare the main sections of a cash flow budget

Describe the sources of information for preparing the cash flow budget, the budgeted income statement and the budgeted statement of financial position

Identify stress points made evident by the budget, and make a plan for management of these

Use the cash flow budget to test different scenarios

Introduction

Business goals and methods support every veterinary workplace environment, whether private practice, not-for-profit, industry or government departments. One of managements' key tasks is planning for achievement of goals.

Forward planning is a process of, first, establishing short and long term business goals. Second, business goals need to be supported and expressed in a formal, written business plan, and this plan needs to include financial reports including budgets and forecasts.

This Learning Guide is limited to cash flow budgets. For information on how to create budgeted Income Statements and budgeted Statements of Financial Position refer to Chapter 17 of Budgeting in Accounting: Building Business Skills (Carlon et al., 2012).

The cash flow budget is but one of many

It is important to understand that there are different kinds of budgets. The various versions of business budgets all reflect business goals and objectives for a specific, future period of time. Budgets and forecasts support and underpin short term business plans. Budgets are not always expressed in monetary terms. For example, a production budget is usually expressed in volume of output terms (e.g. for a feedlot the budget is expressed in kg of beef live weight, or kg of beef dressed weight).

Some different kinds of budgets are, for example:

- Operating budget
- Revenue budget
- Expense budget and subsets (e.g. labour budget, fixed costs budget, variable costs budget)
- Budgeted Income Statement (also known as a Profit and Loss Forecast)
- Capital budget
- Resource budget
- Development budget
- Cash blow budget

Benefits of budgets

The main benefits of budgeting are:

1. In establishing a budget, one is forced to study the related aspect of the business being budgeted for. The cash flow budget, relates to every aspect of the business.This can lead to finding new ways of increasing profit.
2. Goals are set for everyone to work towards, knowing that profits will result if the job is performed effectively.
3. It enables business managers to delegate responsibility without loss of control. If the results of budget development conform to the management plan, business can concentrate on future developments.
4. It encourages the team to think, work collectively and increase joint effectiveness.
5. It clearly defines the individual's responsibility given responsibility for an area covered by the budget.
6. Any adverse change in trade conditions can be evaluated and acted upon to minimise effect.
7. It enables maximum use to be made of available financial resources.
8. Management can examine the effects of policies prior to decision-making.
9. Budgeting is the only way of determining when and to what extent additional finance may be necessary.
10. Businesses with comprehensive budgets find greater favour with financiers and their Board of Directors.
11. Budgets are useful for risk management and testing scenarios

As indicated above, budgets can be used as a motivational and inclusivity tool by management. For management purposes, it is preferable that the budget is established at attainable levels which motivate staff by promoting performance with an emphasis on cost control.

Budgets and forecasts are for a period of time

Budgets are prepared for specific lengths of time. In most businesses a budget is prepared for a period of one year, although most large organisations establish budgets for periods of five years. For a typical cash flow budget, forecasts are usually broken down into monthly figures for a twelve month period, although this may vary, e.g. businesses with quarterly billing cycles. Preparation of the budget before the financial year begins is highly worthwhile even though the actual result of the previous year may not be known in detail at this point in time. The budgeted Statement of Financial Position is one budget that is for a point in time as it is a forecast of where the Statement of Financial Position (Balance Sheet) is planned to be at the end of the budgeted period.

Operational business plans are generally created for the next twelve months. Whereas strategic business plans usually cover the next three to five years. Financial components of a business plan are termed budgets, projections or forecasts.

Financial budgets, projections and forecasts are strong indicators of the potential for success or failure of a business. Components of a business's financial plan typically consist of short range (one year) and long range (three, four and/or five year) planning. Financial expression of business plans are represented in the following:

- 1, 2 and 3 years of cash flow budgets – year 1 broken into months but years 2 and 3 annual
- 1, 2 and 3 years of forecasted Income Statements (profit and loss projections)
- 1, 2 and 3 years of forecasted Statements of Financial Position (balance sheet projections)

Together, the cash flow budget, forecasted income statements and forecasted statements of financial position can be used to generate a reasonable estimate of a business's financial future, but equally important, is the process of thinking through the financial plan to improve the business owner or manager's insight into the financial workings of the business.

Importance of the cash flow budget

The cash flow budget is the most important budget that a business must create. In order to cover business expenses, it is essential to monitor monetary incomings and plan ahead to meet outgoings. Without cash flow a business will grind to a halt. Staff and expenses, such as drugs and other overheads, need to be paid. The business owner requires money with which to repay borrowings, cover return on investment and supply a wage equivalent to the business owner. Even not-for-profit enterprises need cash flow and some profit to be sustainable.

The cash flow budget reflects and also permeates every level of business activity, integrating sales plans, expense plans, asset requirements and financing and should always be linked to the strategic, or business, plan. For a veterinary practice, cash flow budgeting is of particular importance. Veterinary sales income is generally received in small amounts, on a daily, weekly or monthly basis (if accounts are offered). Outgoings for a veterinary practice are generally in small, medium and large amounts. Receipts and outgoings are not necessarily synchronised and as such there may be a short fall at times. Hence, there is need for anticipation of these times, which is achievable using a cash flow budget. Also, in times of excess cash in the bank, plans can be made for best use of the money, and at the very minimum some can be put aside to earn a higher interest rate than that offered by the working account for the business. Again, the cash flow budget makes it possible to effectively manage business finances.

Effective budgeting

The following factors lead to effective budgeting:

1. An accurate accounting system (i.e. the financial statements and reports for the business)
2. A clearly defined and realistic policy to underpin the budget period (from strategic plan)
3. Active participation by leaders (do not delegate to administrative assistants)
4. Enabling team members/staff to participate in the budgetary process will promote alignment with the business's goals.
5. Determined administrative responsibility for regular preparation and reporting to a person or a department
6. A degree of flexibility - plans expressed through budgets are based on the facts available at that time
7. Use of realistic figures and achievable targets.

Construction of a cash flow budget

The cash flow budget shows anticipated cash flows, and the aim is to expose times of anticipated mismatch of incoming monies to outgoing monies, i.e. shortages or excesses. Once exposed, steps can be taken to make arrangements for these times. The cash flow budget contains the following main sections:

- Anticipated incoming receipts (monies) from sales or other
- Outgoings for operational expenses
- Outgoings for investments and financing of the business

The recommended cash flow budget for a veterinary business is the twelve month cash budget, i.e. showing each month's cash position. As this budget can be quite extensive it is useful to prepare separate schedules for incomings and outgoings and then import the respective schedules or their subtotals into the budget.

Listed below are a number of steps to follow when setting up a monthly cash flow budget for a business such as a veterinary business:

1. Gather relevant financial statements, reports and knowledge
2. Set up a monthly schedule for expected money inflows

3. Set up monthly schedules for expected payments for outgoings – operational, investment and financing
4. Then set up and populate a spreadsheet such as an excel file with rows for:
    - Months of the year e.g. July ->June, and Total Year
    - Opening bank balance
    - Cash incomings (receipts and asset sales)
    - Outgoings – operational (purchases and overhead)
    - Outgoings – investment & financing
    - Net cash flow (excess or deficiency of available cash over outgoing payments)
    - Closing bank balance

5. Create subtotals and totals for each column
6. Create tests to make sure the monthly components in the rows add up to the yearly figure (reconciliation)
7. Create the budgeted ending cash balance for each month
8. Create the beginning cash balance for the next month

More detail on the above steps follows below. An example of part of a cash flow budget for a four month period is shown in Table 1 below.

Table 1: monthly cash flow budget for a 4 month period

Allansville Veterinary Practice Cash Budget 2014 - 2015				
	Jul	Aug	Sept	Oct
Beginning cash balance (at bank 1st July 2014)	-1950	-6,029	-1.828	8.948
Add: Cash receipts (from cash and aged receivables schedule)	74,975	76,714	77,931	78,783
Add: other incomings e.g. sales of investments	0	0	0	0
Less: Outgoings–operational (from schedule)	76,944	70,403	65,044	77,694
Less: Outgoings–Investments and financing (from schedule)	2,110	2,110	2,110	4,780
Total outgoings	79,054	72,513	67,155	82,475
Net cash flow - excess (or deficiency) of available cash over outgoing payments	-4079	4,200	10,776	3,692
Ending cash balance (at bank 30th June 2015)	-6,029	-1,828	8,948	5,256

The table above makes the cash flow budget look simplistic, but in reality there is a lot of data to be incorporated.

1. Gather relevant financial statements, reports and knowledge

Data for populating the spreadsheet is obtained from historical information and other budgets if they exist, and from information known to management. The Income Statement, either for the full twelve months, or from monthly Income Statements from the year prior, is a good source of information for this schedule.

In practice, cash flow budgets are prepared for the year in advance, on a monthly basis. For a veterinary practice, knowledge of seasonal effects on income and typical patterns of outgoings is helpful.

The relevant information required to create a month by month annual cash flow budget for a veterinary business includes:

Cash receipts from the last 12 months

Aged receivables for monies owed to the veterinary business (e.g. 30, 60, 90 day balances)

Income statements (Profit and Loss)

Knowledge of seasonal effects on income (obtain from monthly income statements)

Knowledge of typical patterns of outgoings – ad hoc, quarterly, monthly, fortnightly, weekly

Principal (capital) and interest payments for loans and the pattern for these

Tax payments – GST, PAYG, (do not include personal tax)

Opening bank balance –from the relevant bank statement or from the Statement of Financial Position (Balance Sheet)

2. Set up a schedule of expected money inflow

Income for veterinary practice businesses is from two main areas:

- sale of services and animal health items and these are either paid for on the day of sale or sometime in the future (if credit allowed e.g. for long term clients)
- non-operational sales, such as the sale of a motor vehicle.

For a veterinary practice, the bulk of incoming money will be for sale of services and/or animal health items. Receipt of some of this money may not be in the same month that the veterinary work was done. Some of the money will be received by the business at a time later e.g. during the next month. Incoming cash receipts for the typical veterinary business will be for veterinary work done and paid for immediately (cash sales) or within the period, and collections for veterinary work done in a period. This will include value added tax component (e.g. Goods and Services Tax-GST, or VAT if in other countries).

The other incomings section of the cash flow budget is to include anticipated money inflow from non-operational sales. Examples of non-operational sales include sales of investments, plant and equipment and in the case of a company, issue of shares.

Table 2: Example for Allansville Veterinary Clinic cash and collectables schedule July 2014 – June 2015

ASSUMPTIONS:
60% of sales are paid within the month (at time of service) while 40% of each months sales are left on account
35% are paid by the end of the next month while 65% of outstanding accounts are still unpaid up by the end of the next month

All below include GST	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	June	YEAR
Outstanding from previous month	101839	98504	96335	94926	94010	93415	93028	92776	92613	92506	92437	92392	
Total sales made during the month	***80770***	***80770***	***80770***	***80770***	***80770***	***80770***	***80770***	***80770***	***80770***	***80770***	***80770***	***80770***	***$969,245***
Total due	182609	179274	177106	175697	174781	174185	173798	173547	173383	173277	173208	173163	
Receipted	84106	82938	82180	81686	81366	81157	81022	80934	80877	80840	80815	80800	$978,721
Outstanding at end of month	98504	96335	94926	94010	93415	93028	92776	92613	92506	92437	92392	92363	$92,363
Non-operational income													
Total Receipts	$84,106	$82,938	$82,180	$81,686	$81,366	$81,157	$81,022	$80,934	$80,877	$80,840	$80,815	$80,800	$978,721

It is useful to prepare a schedule for anticipated money inflow to the business separate to construction of the actual cash flow budget. These percentages can be estimated by using the previous twelve months aged receivables reports for the business. As an example, consider a veterinary business such as one of the case study practices, Allansville Veterinary Clinic (AVC). For AVC the general payment pattern seems to be that only 60% of clients actually pay at the time of service, while the other 40% have their veterinary work put on account. Accounts outstanding accounts past the end of the month in which the work has been done (i.e. the first month) are paid by the end of the second month, while 65% of the outstandings are still unpaid by the end of the second month. Table 2, above is an example of an anticipated money inflow schedule for Allansville Veterinary Clinic. The example demonstrates the combined effect of a delay in payments for veterinary services and seasonal variation in sales. The calculations behind the table can also be viewed in the excel spreadsheet for Allansville Veterinary Practices cash flow budget and forecasts in the Veterinary Introduction to Business and Enterprise website http://www.adelaide.edu.au/vetsci/vibe/student-resources/case-studies/allansville/.

3. Set up schedules of expected payments for outgoings

As discussed above, the major categories of outgoings for a business are operational, investment and financing. The payment of these will not be directly related to when monies come in to the business from sales.

Operational outgoings (expenses) are incurred by veterinary businesses just like any other business, and these include, for example, wages, purchases and electricity. Payments for operational outgoings are not necessarily evenly distributed over the year, with different expenses needing payment predictably on either a weekly, monthly, quarterly or annually basis and some on an ad hoc basis. Seasonality of business activity and/or other patterns may affect payment amounts over the year. It is wise to create a schedule in which to work out the detail, then transfer the totals for each month to the cash flow budget itself. This schedule will be multiple rows in a spreadsheet and include such operational expenses such as purchases, wages, GST. It does not include depreciation.

Examples of operational outgoings schedule and their payment frequency are shown in Tables 3 and 4 below:

Table 3: Examples of operational expenses and their payment frequency and terms

Operational Expense	Payment frequency	Terms
Drugs & materials, external labs and visiting specialists	Monthly	30 days or less
Maintenance e.g. garden gutters, repairs	When required, or monthly	At the time
Electricity	Monthly or quarterly	30 days or less
Water rates and council rates	Quarterly	By the due date
Wages	Weekly or fortnightly Locums may be as required	By the Thursday of the week or the second week
Superannuation	Quarterly	
Rent	Monthly	On the first day of the month ahead
Drug and merchandise purchases	Monthly	By 21st of the month after purchase
Subscriptions and insurances	Annually	By the due date
All the rest e.g advertising, telephone, laboratory	Monthly	30 days or less
Operating Leases (for plant and equipment)	Monthly	On the designated due date (usually by direct debit from bank account)
Interest component of finance leases (used to be known as hire purchase)	Monthly	On the designated due date (usually by direct debit from bank account)

Table 4: Example of some rows from an operational expenses schedule.

	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	June
Net GST (in - claimable	$5,000	$6,000	$7,000	$8,000	$8,000	$7,000	$6,000	$6,000	$6,000	$6,000	$5,500	$5,000
Payment drugs purchased last month	$22,000	$20,000	$22,000	$24,000	$28,000	$32,000	$28,000	$24,000	$24,000	$24,000	$24,000	$20,000
Garden	$200		$200		$200	$200		$200		$200	$200	$200
Wages	$20,000	$22,000	$24,000	$28,000	$32,000	$28,000	$24,000	$24,000	$24,000	$24,000	$20,000	$22,000
Electricity	$800	$800	$700	$600	$700	$750	$800	$800	$700	$600	$700	$750
Rates	$800	$200		$800	$200		$800	$200		$800	$200	
etc												
Totals	$48,800	$49,000	$53,900	$61,400	$69,100	$67,950	$59,600	$55,200	$54,700	$54,600	$50,600	$47,950

4. Set up and populate a spreadsheet for the cash flow budget.

The cash flow budget is set up as illustrated in Table 6, below, with columns for months of the year ahead e.g. July ->June, and rows for the following:

Beginning cash balance (in bank)

Receipts - cash sales, collectables and any other non-sales related income anticipated (import schedule totals of these for each month)

Outgoings (operational) – import the schedule totals for each month

Outgoings (investments and financing) – showing expected payments for purchased inventory, plant and/or equipment or other assets, expected borrowings and the repayment of borrowed funds plus interest Ending cash balance

Investment outgoings are payments for purchased inventory, plant and/or equipment or other assets. For the purposes of a veterinary practice cash flow budget, in which cost of goods sold includes the cost of external services used on behalf of clients, and that inventory is a current asset, inventory cost is incorporated into the operational expense schedule. For more information please read the Learning Guide, Pricing of Animal Health Items. Examples of outflows of cash for the investment section of the cash flow budget include $10,000 for a major piece of plant or a $3,000 monthly capital payment of a loan. Financing outgoings include expected borrowings and the repayment of borrowed funds plus interest, including finance lease capital components Table 5, below, is an example of a schedule for investment and financial outgoings. For the purposes of simplicity these are combined as often capital and interest payments are made in combined monthly loan payments.

Table 5: Example of a combined investment and financing outgoings schedule.

	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	June
Plant & equip't (P & E) high value pool (VP)						$20,000						
P & E low VP												$6,000
Capital & Interest 2 year Equip Loan	$1000	$1000	$1000	$1000	$1000	$1000	$1000	$1000	$1000	$1000	$1000	$1000
Interest only build'g loan	$10,000	$10,000	$10,000	$10,000	$10,000	$10,000	$8,000	$8,000	$8,000	$8,000	$8,000	$8,000
Totals	$33,000	$31,000	$33,000	$35,000	$39,000	$63,000	$37,000	$33,000	$33,000	$33,000	$33,000	$35,000

Table 6: A 12 month cash flow budget template

Veterinary Practice X Cash Budget 2014 - 2015												
	J	A	S	O	N	D	J	F	M	A	M	J
Beginning Cash Balance (at bank 1st July 2014)												
Add: Cash Receipts (from cash and collectables schedule)												
(Total Available Cash) – optional row												
Less: Outgoings – Operational (from schedule)												
Less: Outgoings – Investments and financing (from schedule)												
Total Outgoings												
Excess (or deficiency) of available cash over outgoing payments												
Ending Cash Balance (at bank 30th June 2015)												

5. Create subtotals and totals for each column

Create equations to treat the data in each column of the cash flow budget, such that:

Outgoings(operational) + outgoings(investments + financing) = total outgoings

Cash receipts – total outgoings = excess/deficiency

6. Test the equations – reconciliation

Create equations for each row to subtotal each line. Create equations to test the reconciliation of the row totals and the column totals. Test out that the same answers can be arrived at two ways.

7. Create the budgeted ending cash balance for each month

Excess/deficiency + beginning cash = ending cash balance

8. Create the beginning cash balance for the next month

The closing bank balance for each month becomes the opening bank balance for the next month. Use spreadsheet functions to automate this. See Table 7, below, for an example of three months of a cash flow budget showing the net cash and the closing bank balance at the end of each month. The example also shows how the closing bank balance becomes the opening bank balance for the next month.

Table 7: A simplified example of three months of a twelve month cash flow budget

Veterinary Practice X Cash Budget 2014 - 2015			
	FEBRUARY	**MARCH**	**APRIL**
Beginning Cash Balance (at bank)	**-35456**	**-5456**	**-8456**
Cash Receipts	110,000	77,000	110,000
Outgoings - operational	-55,000	-60,000	-55,000
Outgoings – investment	-25,000	-20,000	-25,000
Outgoings - financing	0	0	-17,500
Excess/deficiency	**30,000**	**-3,000**	**12,500**
Ending Cash Balance (at bank)	**-5456**	**-8456**	**4044**

Budget principles and caveats

In Table 8, below, is a summary of principles, don'ts and cautions for budgeting:

Table 8: A summary of budget principles and caveats.

Principles	Five Don'ts when constructing a budget or a forecast	How budgets can go wrong
Must be realistic	Don't just add x% to last year's figures	Over optimistic
Must be flexible	Don't indulge in wishful thinking	Understate performance
Management and Team member participation during preparation builds support & confidence in the plan	Don't be deliberately pessimistic	Budget goals may need actual requirements
Must be effectively communicated	Don't deliberately "pad the budget"	Dictatorial budgets may stifle
	Don't use budgets politically (e.g. to empire build by taking on excess staff or resources)	Complex, unwieldy, expensive
		Compound past mistakes
		If too inflexible

So I have a cash flow budget – now what do I do with it?

Once set up, the cash flow budget can be, and should be, used in three key areas:

- From which to create budgeted financial statements (Income Statement and Financial Position Statement) to correspond to the period
- As the basis upon which to regularly review actuals against objectives
- As a tool to undertake 'what if' analyses

1. What next - budgeted financial statements for the next 12 months

Once the cash flow and other sub budgets have been created, a budgeted Income Statement (Profit and Loss) and a budgeted Statement of Financial Position can be created. Once established, these can be used for forecasting purposes, and also against which to evaluate performance.

Data for the budgeted Income Statement is obtained from the cash flow budget with the addition of provision for depreciation. Depreciation does not appear in the cash flow budget as it is not actually real cash that can be put into or taken from a bank account.

The budgeted Statement of Financial Position is a projection of the financial position of the business at the end of a period, and in this case at the end of the 12 months covered by the cash flow budget and the budgeted Income Statement. Data for the budgeted Statement of Financial Position is derived from:

the actual Statement of Financial Position at the end of the preceding year (i.e. the day before the budget period starts for example 30th June 2014, for 1st July 2014

budgeted figures for the coming year for items (e.g. property, plant and/or equipment acquisition, loan pay down, drawings by partners, share dividends, share capital raising)

2. Regularly review actuals to budgeted objectives

Budgeting is a management tool, and management accounting is flexible and used by those working in and on the business on a daily basis, rather than by the taxation accountant. If using a business computer program, budget reports can be produced at whatever interval or frequency suits the need. For example, the cash flow actuals against budget can be produced weekly if a business has concerns about having sufficient cash to pay wages and bills.

Comparison of actuals to budgeted figures as the year progresses enables revision of business operations to constantly align, or even better, outperform the budget. Once a budget is developed, the three R's should be applied:

Review - analyse variances between actual and budget on a regular basis

React - take corrective action if the variance is unfavourable

- Revise - modify future plans and the budget

3. Undertake 'what if' analyses – for risk and opportunity management

Anticipation of future events and planning for times of negative and positive balances is critical in business and this is where the cash flow budget is extremely important.

Budgets, and most importantly the cash flow budget, can be used for sensitivity analysis for a variety of hypothetical scenarios. For example, budgets can be adjusted for anticipated worst case and best case scenarios. The implications of different scenarios occurring can then be discussed and forward plans for such scenarios can be made.

An example for a mixed practice is a drought scenario budget that aims to predict the effect of drought on practice income. Another is a budget for an exotic animal disease outbreak. A small animal practice may wish to create a budget in the case of a fire in the building.

As such, budgets can be used to make informed decisions about projects or scenarios, anticipated future problems or business opportunities. This can be a very powerful application and use of budgets.

References & Acknowledgements

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Lindsay, N., Director Entrepreneurship, Commercialisation and Innovation Centre, University of Adelaide, South Australia.

Authors

Dr Adele Feakes, Lecturer, School of Animal and Veterinary Sciences, Roseworthy campus, The University of Adelaide

Dr Dana Thomsen, Researcher, School of Animal and Veterinary Sciences, Roseworthy campus, The University of Adelaide