

HOW TO BE PROFITABLE DURING BOTH GOOD AND BAD TIMES - BUDGETING

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In last month's newsletter, I described the preparation an Open-To-Buy, the second step in planning to be profitable. As a re-cap, the five steps to being profitable are:

1. Prepare an annual Gross Margin Plan
2. Use an Open-To-Buy
3. Prepare an annual pro-forma Income Statement (budget, done by month)
4. Prepare an annual Cash Flow Projection (done by month)
5. Track the productivity of their selling staff

In this, the fourth installment of this 6 part series, we will discuss putting together your Pro-Forma Income Statement or Budget, the road map for your success.

The Budget will be prepared in the same format as your company's current Income Statement. It is to be completed for the entire year, by month. The information needed to complete the Income and Cost of Goods Sold sections are available on the Gross Margin Plan and Open-To-Buy. As you will recall, the Open-To-Buy gives us the planned sales, inventory and Open-To-Buy (receipts) by month. The inventory and monthly receipts from the Open-To-Buy are at retail and will have to be converted to cost by subtracting from 100 the IMU% shown on the Gross Margin plan (i.e. $100 - 55 \text{ IMU\%} = 45 \text{ percent cost}$). Once you know the planned cost percent just multiply the planned retail inventory and receipts by that percent to get the cost figures you need for the cost of goods sold section of the budget. The Gross Margin Plan gives us the overall company Initial Markup percent and the Gross Margin percent. The only other items needed for the Cost of Goods Sold section are: Purchase Discounts and Freight-In. Usually, these two items can be budgeted based on last year's expense. This year, Freight-In should be lower than last year's actual numbers since fuel prices have been significantly reduced.

All that is left now is to budget the company's expenses and other income items. Before starting this it is a good idea to review your expense structure to make sure it is adequate.

CLASSIFICATION OF EXPENSES

The basic ingredient of expense control is an effective expense classification system. Without a systematic and meaningful method of recording expenses, valuable comparisons and analysis cannot be made. Using the industry standard expense classifications allows you to compare your results with industry averages and statistics so you can see how you are spending your expense dollars in comparison to other similar retailers. This can help you spot areas where your expenses may be out of line.

The National Retail Federation has a standard expense classification system for retailers called the Natural Divisions of Expense. All the normal expenses associated with the usual operation of a retail store will easily fit into one of the 16 categories included in the Natural Divisions of Expense. The 16 basic categories are:

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|-----------------------|--|
| 1. Payroll | 9. Pensions |
| 2. Advertising | 10. Insurance |
| 3. Taxes | 11. Depreciation |
| 4. Supplies | 12. Professional Services |
| 5. Services Purchased | 13. Bad Debts |
| 6. Unclassified | 14. Equipment Rentals |
| 7. Travel | 15. Equipment Maintenance & Service Contract |
| 8. Communications | 16. Real Property Rentals |

You will note that these are not listed alphabetically. Payroll is first because, after Cost of Goods Sold, it is the largest expense item. Advertising is next. Real Property Rentals, although a significant expense, is listed last because the only time you have control over it is when you negotiate your lease.

Each of the above Natural Divisions of Expense can, and in most cases should, be expanded to give a more detailed accounting of expenses. For example, Advertising can be further sub-divided into:

Newspaper
 TV & Radio
 Direct Mail
 Other
 Display
 Merchant's Assoc.
 Agency Fees
 Web Page Expenses
 Trunk Show Expenses

Likewise, payroll can be divided into a number of specific line items. Small stores may need only 2 or 3 while larger stores may need all listed here.

Management
 Office
 Display
 Janitor
 Receiving & Marking
 Selling
 Cashiers & Gift Wrap
 Buyers

EXPENSE CONTROL: PLANNING OPERATING EXPENSES

How do you go about planning expenses for next year? One method is to look at the company's historical records to determine how much each expense was last year, then adjust that amount for inflation and other factors for the coming year. For example, if you have heard on the news that electricity rates are going up by 15% in your area, you would plan this year's expense 15% higher than last year. Items such as Depreciation normally do not change from year to year, unless you have made a purchase of a capital item, such as new fixtures or computer equipment. Another expense that does not normally change from year to year is your rent. That item is set when you sign your lease agreement – so be very careful and negotiate the best possible terms! Some expenses, such as Credit Card Fees, can be planned as a percentage of sales since this does not normally change from year to year (unless, of course, the credit card processing company has raised your discount percent). Advertising is an expense item that you have a lot of control over. I normally recommend this

be budgeted as a set percent of sales. How high it will be depends, in a large measure, on where you spend your advertising dollars. Email advertising is very inexpensive while TV and print advertising is expensive.

Another method is called zero-base budgeting. Zero-base budgeting requires that you start from zero and justify every expenditure. It examines the costs and benefits of all expenditures.

Whichever method you use, and it may be a combination of the two, this is a good time to thoroughly review all the company's expenses to find new and better ways of doing things or discover what things can be eliminated entirely. For example, would an outside alteration service work as well for your store and be less expensive than an in-house tailor? Are there housekeeping tasks you are doing yourself, such as cleaning windows and waxing floors that could be done cheaper by outside contracting services? Don't continue doing things just because that is the way things have always been done. Re-examine and re-evaluate your practices. Every expense dollar saved is added to the bottom line for increased profits.

We recommend a budgeting process that normally includes budgeting for a minimum of 55-65 General Ledger accounts that appear on the Income Statement. It must be detailed enough to give you an exact accounting of where all the dollars are being spent. It does not do you much good to know that supplies are too high. It is much better to know that Office Supplies are too high so you know where to start looking to reduce costs.

EXPENSE PLANNING WORKSHEET

Below is a format that may be helpful to you as you go through the process of planning expenses. It is an Expense Planning Worksheet. This form provides an easy way for you to review each expense at it's lowest level - which is the only way you can control expense. The example shows Travel expense. Don't just budget travel expense at a certain \$ amount because that's what it was last year. Look at each component of travel expense. How many buying trips are planned for this year? What is the usual airfare? What is the normal hotel expense? Can you stay in another, less expensive hotel that is a little farther from market, or would the increased cab fare negate any savings you obtain on room rates? These are the kinds of questions you need to be asking yourself as you complete the expense budget. The bottom section of the form provides room to enter any changes to the original plan, along with an explanation of why the plan was changed.

EXPENSE BUDGET WORKSHEET	
GL Account #: _____	
Description: _____	
Planning Period: From ___/___/___ To: ___/___/___	
Specific Expense Items Included: (Sample-Travel- Buying includes airfare, taxi, hotel, meals, tips, parking, etc.	

Plan or Revision Date	Comments, reasons for planning this amount, reasons for changing existing plan, etc.

OTHER INCOME AND OTHER EXPENSE

There are two other sections of the Income Statement that remain to be planned. These are miscellaneous income items that are not part of the operation of a retail store, such as finance charge income if the store carries its own receivables. Also, there might be some miscellaneous expense items that are not part of the store's normal operations, such as Interest Expense. These might also be for a loss due to fire, or some other minor, one-time expense or income item that does not have anything to do with the normal day-to-day operation of a retail store.

FINAL REVIEW

Once all items on the Budgeted Income Statement have been determined, the planned Net Income can be calculated and reviewed for adequacy. If you find it is not adequate, or is showing a loss, now is the time to review all the company's expenses to see where cuts can, and must, be made. By preparing the budget at the beginning of the year, you know where you stand and will have time to make the needed adjustments to your operation.

BUDGET CONTROL DEVICE

Once the annual budget is determined, it should be broken down by month and entered onto a worksheet or hopefully, your internal computer system has a financial reporting system with the following column headings for each month: Planned, Actual, and Variance To Plan. When doing this, keep in mind that your expenses will not occur evenly throughout the year. For example, expenses for Travel-Buying will occur in those months when you go to market. If you live in a northern region where heating costs are significant, Utility expense will be higher in those months.

Then, every month you must review the budget variance. If sales or Gross Margin are below plan or if any expense item is above plan steps must be taken as soon as possible to correct the problem or revise the plan accordingly so it is realistic.

SUMMARY

A good financial management system is a necessity for every business. The preparation of the budget forces you to take a good hard look at your business - where it is, where you want it to be a year from now. Profits do not just "happen". You must realistically set your profit goal and then work towards achieving it.

Keep in mind that profit does not equal Cash. You must have adequate CASH to stay in business. Next month we will discuss turning your Budgeted Income Statement into a monthly cash flow projection.

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