Budgeting

by Sophia

WHAT'S COVERED

What is a budget? You've likely heard this term before, and we've discussed it in some earlier tutorials. But why is a budget important to a business? This tutorial will cover the topic of budgeting. Our discussion breaks down as follows:

1. Budget for a Business

A **budget** is a researched projection of what funds are needed for a specific period of time. Budgets are used for a lot of different things, like planning, controlling, and making decisions within a business.

It's important to have a budget to compare to the actual expenses and revenues. You see, differences between your goals—what you plan for in your budget—and reality can spell potential problems and may require you to take some action to mitigate those problems down the road.

Now, budgets can be anywhere from one to five years. Typically, with one-year budgets, you see a level of detail that is much more specific. In addition, budgets are dispersed to lower levels of the organization throughout the company, such as department budgets and project budgets. This means that you start with a budget for the entire company and then ask lower divisions or departments to come up with their own budgets that are in line with the budget for the entire company.

There are two types of budgets:

- **Cash budget**: The defined immediate cash needs for an organization for a specific and short period of time. These budgets are good for recording things like weekly performance, for monitoring day to day operations and how your cash is being affected.
- **Capital budget**: An analysis of the acquisition of new, long-term investments, such as a building or R&D, regarding whether the organization will be able to successfully afford the investments. This is quite important because you don't want to be spending money on capital that you can't afford in the future. Typically, this is used for big-ticket items like buildings, as mentioned before.

TERMS TO KNOW

Budget
A researched projection of what funds are needed for a specific period of time.

Cash Budget

The defined, immediate cash needs for an organization for a specific, and short period, of time.

Capital Budget

Analysis of the acquisition of new long term investments (such as a building or R&D) as to whether the organization will be able to successfully afford the investments.

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2. Budget and Survival

Organizations have to meet their short-term needs or short-term debts. They also have to meet their long-term liabilities. There are two key ratios that are used to ensure that both of these things happen.

- *Current ratio:* This is the current assets versus current liabilities. The current ratio is determined by dividing the current assets by the current liabilities (A/L). This ratio is used to show how likely a company is to be able to pay off their current debts, or how creditworthy it is. It's generally desirable to have a high current ratio because it's likely that the organization will be able to pay its debts.

  $\text{Current Ratio} = \text{Current Assets} \div \text{Current Liabilities}$

  > ↱ EXAMPLE Suppose you have $4,000 in current assets, like cash on hand. You also have $1,000 worth of current liabilities, such as short-term loans that you've taken. In this case, your current ratio would be 4 to 1. You have four times as many assets as you do current liabilities. That's a good score. A 2 to 1 current ratio is typically considered acceptable within a business.

- *Debt to owner's equity ratio:* This is the debt divided by the owner's equity in a company (D/OE). This is used to show how aggressively a company has been growing in debt. It's generally desirable to have a low number, or a low debt to owner's equity ratio, because it shows that the organization is not relying on debt too much in order to keep its business operations going.

  $\text{Debt to Owner's Equity Ratio} = \text{Debt} \div \text{Owner's Equity}$

  > ↱ EXAMPLE Suppose you have $4,000 in debt and $5,000 in owner's equity. In this case, you have a debt to owner's equity of $4,000 ÷ $5,000, or 0.8. This is considered fairly good because it's less than 1. Basically, it means that the total amount of owner's equity—remember this from the balance sheet?—is greater than the amount of debt that you have. This is typically considered a good position to be in for a company.

SUMMARY

Today we learned about **budget for a business**, including cash budgets and capital budgets. We also learned about **budget and survival**, and the ratios that we can use to help gauge how healthy or creditworthy we are as a business.

Good luck!

Source: adapted from sophia instructor james howard

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Cash Budget

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