



Monitoring and Managing Budgets

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Discuss how to perform basic ratio analysis

Monitoring and Managing Budgets

Test Your Knowledge

In the chart below, record how budgets are monitored and managed in your organization. List the advantages and disadvantages of each method.

| Method | Advantages | Disadvantages |
|--------|------------|---------------|
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Crunching the Numbers

Understanding Ratio Analysis

If you understand simple ratio and proportion analysis, you can get more information and exercise more control over departmental expenses. You can also use ratios to do final reality checks over your budgets by comparing your budgeted ratios to actual ratios from prior periods.

Ratio analysis sounds intimidating but it isn't. Ratios are simply numbers that let us compare. For example, if your car gives you 20 miles to a gallon of gas, and the new SUV you are looking at gives you 10 miles per gallon, you have just done a ratio analysis to compare the operating costs of the two vehicles.

Ratios measure relationships between particular numbers. By periodically plugging figures from your company’s two central financial records (the profit and loss statement and the balance sheet) into certain simple ratio equations, you will be able to track certain aspects of the business. Ratios also enable you to compare one company against industry standards.

Sample Balance Sheet

| Acme Widgets Inc. Balance Sheet For the Month Ended February 28, 2020 | | | |
|--|-----------------|--------------------------------|----------------|
| Assets | | Equity | |
| Cash | \$2,500 | Owner’s Capital | \$5,000 |
| Accounts Receivable | 7,500 | Cumulative Net Income | 3,300 |
| Supplies | 1,500 | Less Withdrawals and Dividends | (1,300) |
| Total Assets | \$11,500 | Total Equity | \$7,000 |
| Liabilities | | | |
| Accounts Payable | \$500 | | |
| Notes Payable | 4,000 | | |
| Total Liabilities | \$4,500 | | |

Additional Facts and Figures

- Gross Sales: \$22,000
- Net Sales: \$17,000
- Gross Profit: \$15,000
- Net Profit: \$10,500

Current Ratio

This is possibly the most common ratio used in the business world. It’s usually presented like any other ratio, with two numbers separated by a colon. This ratio compares assets to liabilities – in other words, what the company owns vs. what it owes. This can give you a quick picture of the health of a company.

The formula for current ratio is:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

So if we used the numbers from our sample balance sheet, we could calculate that Acme Widgets Inc. has a current ratio of about 2.6:1.

A current ratio of about 2 is considered adequate for most businesses. If a business has a relatively unstable cash flow, however, it might be necessary to maintain a current ratio of more than 2.

Quick Ratio

This ratio is very similar to Current Ratio, except that it removes inventory from the calculation of assets, on the assumption that inventory is harder to liquidate than other assets. Anything above 1.5:1 is considered acceptable.

The formula for the quick ratio is:

$$\frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$$

Debt Ratio

The equation for debt ratio looks like this:

$$\frac{\text{Liabilities}}{\text{Assets}}$$

You can then multiply the result by 100 to get a percentage.

Take the business example of Acme Widgets. It has \$11,500 in assets and total liabilities (current plus long-term) of \$4,500. So, for this business, the debt ratio is about 39%. This is a very stable situation – Acme Widgets probably wouldn't have any trouble borrowing money from the bank, and its shareholders would probably be comfortable with this percentage of debt.

Net and Gross Profit Margin

These two ratios measure the amount of money that the business earns as a percentage of overall revenue.

Gross profit margin takes into account only the cost of making the product or service. Therefore, its equation looks like this:

$$\frac{\text{Gross Profit}}{\text{Gross Sales}}$$

The net profit margin shows what the business has earned after selling its products and paying all expenses – the true bottom line. Its equation is:

$$\frac{\text{Net Profit (After Interest and Taxes)}}{\text{Gross Sales}}$$

The results of both equations are expressed as a percentage.

Return on Sales Ratio

Return on Sales Ratio allows a business to determine how much net profit was derived from its gross sales. This ratio is very similar to the Net Profit Margin but it factors in all expenses, including interest.

$$\frac{\text{Net Income (Before Interest and Taxes)}}{\text{Gross Sales}}$$

This ratio tells us whether expenses are under control and whether the business is actually generating enough revenue to pay for its costs. The higher the Return on Sales Ratio, the better it is for the business.

Debt to Net Worth Ratio

Debt to Net Worth Ratio indicates the relationship between a business' net worth and the debt which a business carries. It can be calculated with this formula:

$$\frac{\text{Total Debt}}{\text{Net Worth}}$$

The result of this calculation is an indication to banks and other creditors whether a business can handle additional debt. It is a determination of risk, where a high debt ratio can indicate that the business is carrying a lot of obligation and likely to be hampered in borrowing any additional money. Too low a ratio, however, may indicate that a business is too conservative and could effectively borrow more money to generate more profits. When the ratio is higher than 1, it is an indication that there is too much debt for net worth.

Cash Turnover Ratio

Cash Turnover Ratio provides an indication of how often cash flow turns over to finance your sales. It can be calculated with this formula:

$$\frac{\text{Gross Sales}}{\text{Current Assets} - \text{Current Debt}}$$

When your cash supply is tight, you are having trouble meeting obligations related to business operations like salaries, utilities, paying suppliers, and purchasing inventory. Generally, your cash turnover ratio should be between 4 and 7.

Collection Ratio

Collection Ratio shows the number of days it takes for your business to get paid for sales where you are providing credit.

Here is the formula:

$$\frac{\text{Accounts Receivable} \times 365}{\text{Gross Sales}}$$

This figure should be near the point at which you declare an account overdue. Too long a period means that you are overextending your credit and basically becoming a banker for your slow-paying customers. The period should be no more than 1.5 times your credit overdue period.

Investment Turnover

Investment Turnover Ratio shows the ability of your business to use its assets to generate sales income. Calculate it with this formula:

$$\frac{\text{Gross Sales}}{\text{Fixed Assets}}$$

A good indicator of the strength of your business is your ability to generate more and more sales from a stable asset base. If the ratio is declining, it can indicate that the growth of the business is not being met with a matching growth in sales proportionate to your investment in assets. In general, the higher the ratio, the stronger the business.

Return on Investment

Return on Investment analysis provides a clear indication of business profitability. It shows how much profit a business is able to generate in proportion to its net worth.

The formula is:

$$\frac{\text{Net Profit}}{\text{Net Worth}}$$

This figure shows what level of actual return you are getting on the money which you have invested in your company. Unless you are actively working toward a healthy return on your business investment, your business has little chance to grow and thrive. A respectable goal is to aim for a 12% return in order to remain healthy and viable.

Getting Your Budget Approved

At some point, you will have to build a case to support your budget and present it. Or, you may need to participate in a full-fledged budget review. Below we share a few tips to help you create a powerful presentation to get your budget approved.

Know what to expect.

Get as much information about the presentation as you can.

- When and where will it be held?
- Who will be there?
- Who else will be presenting?
- What do they expect? (Handouts, summaries, graphs, etc.)
- What format should your presentation be in? (PowerPoint presentation, speech, overheads, etc.)
- What do you need to bring? (Tip: Always bring extra copies of handouts.)

Make sure you provide what they expect.

Double-check your budget to make sure it's in the proper format and that all of the elements in the budget package are complete. Make sure that you don't need to complete anything else for your presentation.

Be prepared.

Your presentation should cover the basic points of your case. However, you should also have a well-organized notebook or electronic document handy with all the supporting information. (Another method is to create extra slides in PowerPoint and keep them hidden unless you need them.) This way, you won't overwhelm your audience, but you'll be prepared for tough questions.

Stay calm.

When presenting, go slowly. Pause frequently and ask for questions. Most people have a tendency to talk faster when they are nervous, so make a conscious effort to slow your speech down. If you're presented with a tough question, take a deep breath and collect your thoughts. Don't be afraid to ask for a moment to gather that information – although it shouldn't take too long if you have a document already prepared with extra information. If you don't have the answer, tell the committee the truth – and let them know when they can expect the information.

Do a mock presentation.

Find someone that you trust to give you constructive criticism. Do the entire presentation just the way you will for the budget committee. Ask your judge what things went well and what things you could improve on. In the end, would they approve your budget?