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Budgeting in a Small Service Firm

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Summary

Budgeting is a tool for dealing with the future. It helps you turn expectations into reality.

An increase in profit should be the first consideration when you think about the prospects for your small service business in the next year. Working up a budget helps you to determine whether or not your profit goal is within reach.

When the figures are all together, you have answers to questions such as: What sales will be needed to achieve the desired profit? What fixed expenses will be necessary to support these sales? What variable expenses will be incurred in producing the services?

Because small business is not a cut-and-dried affair, the first budget often will uncover problems and suggest choices. Working up additional budgets will help you decide what changes to make in order to have a workable plan for next year.

Many owner-managers run their businesses without a planned goal. In trying to survive from week to week and from month to month, such owner-managers overlook an important management tool--budgeting. Whether the plan is for next year, for the next 3 years, or for the next 5 years, budgeting can help just as a map helps you to keep on the right road.

Why Budget

A budget is a plan that enables you to set a goal and list the steps which are necessary to reach that goal. Thus, a budget helps you think about what you want your business to do in the future. By planning, you are in a better position to act to prevent crises.

In its simplest form a budget is a detailed plan of future receipts and expenditures--a projected profit and loss statement. Thus once the period for which you have budgeted is completed, you can compare actual results with anticipated goals. If some of your expenses, for example, are higher than you expected, you can start looking for ways to cut them. Conversely, if you have fallen short of your goal, you may want to look for ways to increase your income.

Budget makers can start either with a forecast of sales and work down or with a forecast of profits and work up. Most small service businesses use the latter method. In other words, you decide what profit you want to make and then list the expenses that you will incur in order to make that predetermined profit.

A Plan For Increased Profit

Before you can use a budget as a plan for increased profit, you have to be sure that your present profit is what it should be. In a service business, the year-end profit should be large enough to make a return on your investment and a return on your own work--pay you a salary.

Value Of Owner's Service. Skilled crafts people who own service businesses are kidding themselves if their firms' profits are less than they can earn working for someone else. Your net profit after taxes should be at least as much as you can earn if you worked at your trade for a weekly pay check.

Return On Investment. The year-end profit is too low if it does not also include a return on the owner-manager's investment. That investment includes the money you put into the firm when you started it and the profit of prior years which you left in the firm--retained earnings. You should check to be sure that the rate of return on your investment is what it should be. Your trade association should be able to provide guidelines about the rate of return on investment in your line of business. Your accountant and banker are also sources of help.

Your Targeted Income. After you know what you made last year, you can set a profit goal for next year. Be sure that your goal includes a return on your services and a return on your investment. Your goal should also include an amount for State and Federal taxes. For example, if you want to make $10,000 after taxes, your goal before taxes should be about $13,333. You have to add this $3,333 to take care of State and Federal taxes. Keep in mind that the larger your goal, the larger the amount which will have to be added to account for taxes. Your accountant can help you determine that amount.

Can You Reach The Goal

Once you have decided on your profit target, the next step in preparing a budget is to determine whether you can achieve it. To do this, you must project your fixed costs and your variable costs. From these three figures--profit, fixed expenses, and variable expenses--you can determine your "hoped for" total income.

In gathering figures, keep in mind that without accurate information planning becomes guessing. The owner-manager who has never budgeted should talk with an accountant about a recordkeeping system. Changes may be needed to provide the necessary budget information. It may be that your present system does not break costs down into fixed and variable expenses, or it may be that you need to have a profit and loss (or income) statement at more frequent intervals to determine the seasonal fluctuations of your revenues and expenses.

Fixed Expenses. Regardless of sales, fixed expenses stay the same. Several examples of fixed expenses are insurance, rent, taxes on property, wages paid to salaried employees, depreciation of equipment, interest on borrowed money, building maintenance costs, office salaries, and office expenses.

Variable Expenses This type of expense varies with sales. In some service businesses, the cost of labor is the biggest factor. Sales commissions, payroll taxes, insurance, advertising, and delivery expenses are other examples of variable expenses.

Determine Your Expected Service Income Your expected service income contribution is the difference between sales and the variable expenses that are necessary to produce these sales. When this difference equals fixed expenses and the desired profit, you have a workable budget.

Lucy's Beauty Shop

Lucy's Beauty Shop* illustrates the principals of budgeting in a small sevice business. The owner-manager is Mrs. Lucy Doe. The shop's income is from two sources: (1) from beauty services which are performed by three operators and (2) from cosmetics and perfumes which are sold by the receptionist. The receptionist also answers the telephone, keep's the shop's daily records, and prepares the checks for Mrs. Doe to sign.

Targeted Income In making a budget, Mrs. Doe decided that she wanted to increase her net profit after taxes. She set the goals at $10,000 for net profit after taxes. This figure meant that the shop's profit before taxes had to be about $13,333 because she figured that her taxes would amount to about $3,333.

This goal was an ambitious one because her previous year's net profit before taxes was $8,390. For details on that year see page four. "Lucy's Beauty Shop—Profit and Loss Statement."

Determining Fixed Expenses. As shown in the table, "Lucy's Beauty Shop–Profit and Loss Statement," the shop's fixed expense items are: depreciation of equipment, receptionist's salary, insurance, rent, interest on equipment obligations, and utilities (heat and air conditioning). In addition, about one half of the laundry and shop maintenance expense is fixed. In budgeting her fixed expenses for next year, Mrs. Doe took into account: (1) the raise she intended to give the receptionist, (2) a change in amount of interest, and (3) a change in her insurance expense.

She estimated that her fixed expenses for next year would be $11,000.

Determining Variable Expenses. In Mrs. Doe's beauty shop, the variable expenses—those that vary with sales—are cost of cosmetics sold, shop supplies, payroll taxes and costs, utilities (water and electricity), about one-half of laundry and shop maintenance, and operator's salaries. These salaries are variable because each operator receives one-half of the total price charged the customer.

When determining variable expenses, Mrs. Doe uses her trade journals for information on budgeted percentages. For budgeting purposes, all costs are expressed as a percentage of the sales dollar. In her case, the percentages are: beauty shop supplies 10; laundry, including uniforms 3; water and variable utilities 1; and payroll costs 5.

*Names in Aids are Fictitious

Lucy's Beauty Shop
Profit And Loss Statement
For the Year Ended December 31, 19____

Revenue:					
Merchandise				$12,000	
Beauty Shop Service				42,000	
Total Revenue				$54,000	
Cost of Merchandise Sold				6,000	
Gross Margin					$48,000
Expenses	Variables	Fixed	Total		
Depreciation		300	300		
Salaries and wages	21,000	2,700	23,700		
Supplies	4,200		4,200		
Insurance		110	110		
Rent		4,800	4,800		
Payroll taxes and costs	2,370		2,370		
Interest		250	250		
Utilities	420	1,000	1,420		
Laundry and Shop maintenance	1,260	1,200	2,460		
	29,250	10,360			$39,610
Net Income Before Taxes					$8,390

She estimates her total payroll costs at 5 percent of gross revenue from service or 10 percent of salaries. Payroll taxes both–State and Federal–account for 7.9 percent of the 10 percent, and payment's for workers' compensation and other employee insurance account for 2.1 percent.

Determining Expected Service Income. The next step in preparing a budget for Lucy's Beauty Shop is to determine the expected service income contribution. The basis for estimating this income for next year is the average revenue for each operator's appointment with one customer. This figure is $4. See the following table, "Service Income Contribution."

One half of the $4 belongs to the operator. Other variable expenses take 76 cents. Thus, from each $4 unit of services that is sold, $1.24 is left for service income contribution.

The service revenue for 12 months is shown in the table, "Determination of Total Service Contribution." Mrs. Doe arrived at these estimates as follows:

1. From the appointment book, she learned that each operator averages 15 appointments a day.
2. The shop's income from each operator is $30 a day (15 times $2).
3. Each operator works 5 days a week.
4. Each operator contributes $630 a month to the shop's income (21 days times $30).

Service Income Contribution
Expressed as a Percent of Sales Dollar

Average Service Revenue		$4.00	100%
Variable Expenses			
Operator salaries	$2.00		50%
Beauty supplies	.40		10%
Laundry and uniforms	.12		3%
Water	.04		1%
Payroll costs	.20		5%
Total Variable Expenses		2.76	69%
Income Contribution From Services		$1.24	31%

On this $630, the shop clears $390.60 because 76 cents of each $2 that the shop receives from an operator's work goes for variable expenses (see the table, "Service Income Contribution").

The shop's cosmetic sales contribute a net revenue of 50 cents on the sales dollar. Mrs. Doe estimated, based on past experience, that she could get a 50 percent increase in the sales of cosmetics without additional advertising.

Comparing Revenue and Cost. After Mrs. Doe determines her variable expenses, fixed expenses, and the service income contribution, she is ready to test her budget. She does this by adding her total fixed expenses of $11,000 and the desired gross profit of $13,333. This total comes to $24,333.

But her estimated service revenue (see the table, "Determination of Total Service Contribution,") is only $23,061. It will not cover her fixed expenses and desired profit. Resources will be about $1,300 short of the desired goal.

Determination Of Total Service Contribution

Revenue Per Operator For The Year ($1,260 per month x 12 months)	$15,120
Service Income Contribution Per Operator ($390.60 x 12 months)	4,687*
Total Service Contribution From Beauty Shop (3 operators x $4,687)	14,061
From Cosmetic Sales ($18,000 x 50%)	9,000
Total Service Contribution Based On Present Outlook	$23,061

*Figures are rounded to the nearest dollar.

Where Can She Go?

Because resources are not enough to cover fixed expences and the desired profit, Mrs. Doe has to adjust her budget. She can go in at least three directions. One possibility is to add another operator. Another is to try to increase cosmetic sales. A third solution is to reduce her expected profit. In order to decide what to do, Mrs. Doe needs answers to several questions about each possibility. She may have to work up several tentative budgets to determine what to do.

Add Another Operator. This possibility poses the following questions: Is the relationship between fixed expenses and revenue in line with industry trends? Is there space for an additional booth? What additional fixed expenses will be incurred? Can another operator be kept busy? If so, the additional revenue can help to offset Mrs. Doe's rent which is slightly higher than the average for her line of business. That average is 10 percent of gross beauty service income. The shop has sufficient space for another booth. However, if a booth is added, fixed expenses will increase because equipment for the new booth will mean additional financing costs.

Increase Cosmetic Sales. This possibility seems to be a logical way to increase income because each dollar of sales will increase the revenue by 50 cents. The first question is how much of an increase in cosmetic sales will be needed? Mrs. Doe calculated that these sales must be increased by about 95 percent rather than by 50 percent as she originally planned. Other questions to answer here are: By what method will sales be increased? By what additional advertising? By offering the receptionist and operators a commission on cosmetic sales? By reducing prices? What effect will these methods have on revenue? How much additional inventory will be needed? How will it be financed? Is storage and display space sufficient to accommodate increased sales?

Reduce Expectations. Sometimes the only practical solution is to reduce the expected profit. Mrs. Doe decided that $10,000 net profit after taxes was not in the picture next year. Based on her knowledge of the beauty shop business, she felt that her shop was not quite ready to add another operator. For one thing, she foresaw the possibility of personnel trouble if a new operator was not kept busy.

She also felt that trying to push cosmetic sales up by more than 50 percent could cause customer dissatisfaction. She reminded herself that customers regarded the shop's beauty service highly and decided that any major growth in sales must come from that end of the business. Another operator and $10,000 or more net profit after taxes might be feasible the year after next. She would keep the possibility in mind as she moved into next year.

Periodic Feedback And Control

A budget provides a tool for control. You start building this facility when your budget for 12 months is completed. Break it down into quarters. Such a breakdown allows you to check for any discrepancies that may not show up readily in a 12 month budget. When many items are added together, it is easy for an error to creep into the totals.

During the year, this quarterly division provides a handle for getting a hold on expenses and other activities. For example, by looking at next quarter's budget you can anticipate peak periods and schedule stock and labor to handle peak sales volume. You can plan vacations, special promotions, and inventory taking for the slow periods.

A monthly or quarterly profit and loss statement allows you to keep the items in your budget in line with operations. Ask your accountant to show the actual and the planned revenues and expenses on the income statement so you can compare them. Thus, you can pinpoint and work on the problems that have occured during the month or the quarter. Your objective is to guide your activities toward the most profitable type of operations.