Case study – Business start-up – Budget versus actual

This is the solution to the case study found at the end of:

- Chapter 8 *Budgeting*

Part 1

Working

Sales receipts can be estimated as follows from the information given in notes 1 and 2.

Month	Calculation	£
1	70 customers per day for 26 days x £2.50 average spend	4 550
2	75 customers per day for 26 days x £2.50 average spend	4 875
3	75 customers per day for 26 days x £2.50 average spend	4 875
4	80 customers per day for 26 days x £2.50 average spend	5 200
5	80 customers per day for 26 days x £2.50 average spend	5 200
6	85 customers per day for 26 days x £2.50 average spend	5 525
7 – 12	90 customers per day for 26 days x £2.50 average spend	5 850

Cost of sales is, in each case, estimated at 28% of sales revenue (if gross profit percentage is 72%, cost of sales percentage is therefore 28%).

From this, and the information and assumptions given, it is now possible to prepare the cash flow forecast, and the budget profit and loss account and balance sheet:

Pete: Cash flow forecast for first year of trading

	1	2	3	4	5	6	7	8	9	10	11	12	
Month	£	£	£	£	£	£	£	£	£	£	£	£	Total

Receipts (sales)	4 550	4 875	4 875	5 200	5 200	5 525	5 850	5 850	5 850	5 850	5 850	5 850	65 325
Payments													
Cost of sales (28%6sales)	1 274	1 365	1 365	1 456	1 456	1 547	1 638	1 638	1 638	1 638	1 638	1 638	18 291
Legal fees	1 000	—	—	—	—	—	—	—	—	—	—	—	1000
Launch party	2 300	—	—	—	—	—	—	—	—	—	—	—	2300
Advertising	1 000	—	400	—	—	200	—	—	—	—	—	—	1600
Wages	233	233	234	233	233	234	233	233	234	233	233	234	2 800
Rental	1 875	—	—	1 875	—	—	1 875	—	—	1 875	—	—	7 500
Business rates	—	—	2 600	—	—	—	—	—	—	—	—	—	2600
Water rates	72	72	71	72	72	71	72	72	71	72	72	71	860
Power, heat, light	—	—	200	—	—	200	—	—	200	—	—	200	800
Phone charges	—	—	100	—	—	100	—	—	100	—	—	100	400
Insurance	500	—	—	—	—	—	—	—	—	—	—	—	500
Accountant's fees	—	—	—	—	400	—	—	—	—	—	—	400	800
Drawings	900	900	900	900	900	900	900	900	900	900	900	900	10 800
Total payments	9 154	2 570	5 870	4 536	3 061	3 252	4 718	2 843	3 143	4 718	2 843	3 543	
Opening balance	(8 000)	(12 604)	(10 299)	(11 294)	(10 630)	(8 491)	(6 218)	(5 086)	(2 079)	628	1 760	4 767	
Add: receipts	4 550	4 875	4 875	5 200	5 200	5 525	5 850	5 850	5 850	5 850	5 850	5 850	
Less: payments	(9 154)	(2 570)	(5 870)	(4 536)	(3 061)	(3 252)	(4 718)	(2 843)	(3 143)	(4 718)	(2 843)	(3 543)	
Closing balance	(12 604)	(10 299)	(11 294)	(10 630)	(8 491)	(6 218)	(5 086)	(2 079)	628	1 760	4 767	7 074	

<u>Pete: Budget profit and loss account for first 12 months of trading</u>

	£
Sales	65 325
Less: cost of sales	(18 291)
Gross profit	47 034
Expenses (excluding depreciation)	(21 160)
Depreciation: £13 000/5	(2 600)
Net profit	--------
	23 274

<u>Pete: Budget balance sheet at the end of year 1</u>

	£
Fixed assets at cost	13 000
Less: accumulated depreciation	<u>(2 600)</u>
Fixed assets at net book value	10 400
Cash at bank	<u>7 074</u>
	17 474
Loan: Dave	(3 000)

	<u>14 474</u>
Capital: Pete	2 000
	23 274
Profit for year	
Less: drawings	<u>(10 800)</u>

	<u>14 474</u>

Part 2

(a) The completed statement should be as follows:

Month	1 Actual £	1 *Budget* £	2 Actual £	2 *Budget* £	3 Actual £	3 *Budget* £
Receipts (sales)	2 604	*4 550*	2 998	*4 875*	3 016	*4 875*
Payments						

Cost of sales	774	*1 274*	929	*1 365*	944	*1 365*
Legal fees	1 200	*1 000*	—		—	
Launch party	1 907	*2 300*	—	—	—	—
Advertising	980	*1 000*	—	—	—	*400*
Wages	200	*233*	180	*233*	—	*234*
Rental	1875	*1 875*	—	—	—	—
Business rates			—		2 600	*2 600*
Water rates	72	*72*	72	*72*	71	*71*
Power, heat, light	—	—	—	—	190	*200*
Phone charges	—	—	—	—	87	*100*
Insurance	505	*500*	—	—	—	—
Accountant's fees	—	—	—	—	—	—
Additional expenses	250		300		424	
Drawings	900	*900*	900	*900*	900	*900*
Total payments	8 663	*9 154*	2 381	*2 570*	5 216	*5 870*
Opening balance	(8 325)	*(8 000)*	(14 384)	*(12 604)*	(13 767)	*(10 299)*
Add: receipts	2 604	*4 550*	2 998	*4 875*	3 016	*4 875*
Less: payments	(8 663)	*(9 154)*	(2 381)	*(2 570)*	(5 216)	*(5 870)*
Closing balance	(14 384)	*(12 604)*	(13 767)	*(10 299)*	(15 967)	*(11 294)*

(b) In the first three months of trading, actual sales fall a long way short of the budget estimates. In month 1, actual sales are 57% of budget; in month 2 they are 61% of budget and in month 3, 62% of budget. The budgeted gross profit percentage is 72% but actual falls short of that target. Actual gross profit percentage in month 1 is 70.3%, in month 2 it is 70.1% and in month 3 it falls to 68.8%. Although Pete is managing to keep some of the expenses under control, he didn't allow any contingency for unexpected expenses. With the benefit of hindsight, he really should have put in an estimate for other expenses.

When Pete and Norris negotiated the overdraft facility with the bank manager they did not allow much leeway (or 'headroom' as it is sometimes called). Against a maximum requirement of £12 604 indicated by the budget they allowed a facility of £15 000. This has now been extended to £17 000, but Pete is losing money fast and he cannot continue to do so. It appears that he has misjudged the market and is attracting customers who simply cannot afford to spend very much. He may need to change the type of product he is offering if he wants to stay in business.

Pete should perhaps have been less optimistic about his sales projections. He could have examined a series of 'what if' scenarios at different levels of trading.

After only three months, it is not easy to predict what will happen to the business, but prospects are not looking very good. At least Pete has some accurate and timely management information available to help him make decisions about the future of the business. If he can react quickly enough, he may be able to turn the business around.