

Three-way budgeting

STORY **Amanda Burling & Jed Eden**
Baker Tilly Staples Rodway Taranaki

Ever wonder why your business is making a profit but never has any cash? It's a question we as accountants are often asked, and the answer can vary. What this question does highlight is the importance of doing three-way budgeting, not just a profit and loss budget.





Why should you budget?

Knowing how much cash is coming in and going out of your business is critical information for any business owner. Recognising what is available stops overspending and putting the financial health of your business at risk. Understanding your cash flow situation is vital to setting the foundations for growth, profitability and the long-term success of your business.

Cash flow isn't the only important thing when it comes to financial reporting. You will also be keeping a close eye on your profit and loss and your balance sheet, both of which give you a different perspective on the financial health of your business.

What is a three-way budget?

A three-way budget combines the three key financial reports into one consolidated forecast. It links your Profit & Loss, Cash Flow, and Balance Sheet together so you can forecast your profit, future cash position and strength of your balance sheet. This three-way format highlights the interaction between income and expenses, cash at bank, and your balance sheet position. The benefit of this is that it allows you to analyse how a change in income, expenses, collectability of debtors, loan repayments, or drawings can affect the profitability and liquidity of your business. Ideally, this will then lead to improved decision making and a healthier business.

The age-old adage "you can only monitor what you measure" comes to mind when comparing a profit and loss budget to a three-way budget. Extending your budgeting beyond the profit and loss to include the cash flow and balance sheet, allows the measuring and monitoring of a

wider range of inputs and outputs. This additional information will allow better decision making and a more in-depth understanding of your business.

Monitoring cash flow

Within your business, there is a continuous cycle of cash in and cash out. This cycle needs to be monitored in order to ensure that enough cash stays in the business to cover upcoming payments.

There are a few ways to do this effectively:

- **Produce a cash flow statement** – giving you a full breakdown of your cash in and cash out across the business. This is a historical report that shows you what has happened.
- **Run regular forecasts** – this takes your current cash position and looks forward. Assuming your budgeting around income/expenses, cash in/cash out is accurate, it will show you if you have enough cash to meet your obligations.
- **Use data to enhance forecasts** – from the forecast above, make changes based on real-time information to improve the accuracy of the outcomes.

Creating cash flow forecasts can be time-consuming and complex, but most cloud-based accounting software can automatically produce cash flow forecasts using data from your cloud-based accounting system.

Understanding your P&L

Your profit and loss statement shows all of your income and expenses over a given period of time. It looks at total income and expenses incurred (on an accruals basis generally) over the period rather than cash flow (cash basis). The profit and loss is essentially a historical report, showing what has already happened, rather than future financial positions, but it is good to review your performance, and it

gives a good reference point for budgeting at the start of the year.

Basically, this is the report that shows if you are making a profit and highlights that it is possible to be still profitable but have poor cash flow.

What is my balance sheet telling me?

Your balance sheet shows your assets, liabilities and equity at a given point in time. Assets are the things that you own, cash, equipment, machinery, land etc. Liabilities are the things that you owe people, bank debt, accounts payable. Equity is the investment by the owners, plus (minus) any income (losses) made over time.

This shows you the financial health of your business. Accountants often look to the balance sheet to gauge the strength of the business.

Utilising your budget

Once you have prepared your three-way budget, what's next?

Two well-known sayings spring to mind: "What gets monitored gets managed" and "In business, we need to work smarter not harder."

There are two important parts in preparing a budget, firstly the preparation of the budget and secondly a system to ensure that action is taken when results differ significantly from those predicted.

Speak to your Baker Tilly Staples Rodway advisor about options to suit you and your business; whether that is monthly reporting or quarterly reporting, we work alongside you to get the best results.

amanda.burling@bakertillysr.nz
jed.eden@bakertillysr.nz