

The Breakeven Budget

Do you like accounting? Most people would say no—and that's my position as well. A business major in college, I was grateful that I only had to take one year of accounting. But I do remember some basic concepts. One is the difference between accrual and cash accounting. Failure to understand the difference between these two concepts can get you in big, big trouble.

Here's why: for most of us income is variable. Expenses and other costs are also variable. What kind of budget deals effectively with the variable nature of income and expenses?

The Cash Accounting Method

The cash accounting process records the amount of income received in each time period and the amount of cash spent and expenses paid in that same period. If income and expenses are absolutely equal each month, and all bills are paid on time, money still in your checking account at the end of any month could be spent with no concern about future expenses. Does it ever work out this way? Of course not. Many expenses are paid once a year or are variable. Some expenses are unpredictable. A cash accounting system which only records income and expenses on a month-by-month basis does not provide an accurate picture of whether future income will cover future expenses.

The Accrual Accounting Method

Accrual accounting works differently because it has a one-year, or even longer time horizon. Accrual accounting recognizes that some expenses have been incurred but are not due until later. For example, assume you pay insurance premiums on a quarterly basis, and that \$300 is due at the end of each quarter. In January and February you have no cash requirements for the insurance premiums. But have accrued \$200 in future premiums due.

If you don't set this money aside, and you spend everything you make each month, you're going to be in trouble in the third month of each quarter because you haven't set aside money to pay the insurance premium. Multiply this event by a variety of deferred, variable, or unpredictable expenses and a cash accounting budget will not have set aside funds for these future expenses.

Accrual accounting looks at all expenses, typically for the entire year, and allocates these expenses on a monthly basis. Using the insurance example above, each month the accrual accounting method requires that you set aside \$100. When the premium becomes due in the third month of each quarter, you'll have the cash to pay the bill. You need to follow this same procedure for all your expenses: taxes, cash reserves, future capital expenditures, variable expenses, retirement plan contributions and bonuses.

The Breakeven Budget Process

Accrual accounting is standard procedure for all big businesses. Small businesses should do the same for one very simple reason. It is human nature to spend everything we make. Setting aside funds for future expenditures—whether known or unknown—is a critically important factor in determining whether or not you're running a profitable business. The mere fact that you have cash in the bank at the end of any month is not an indication that you're profitable. The only way that you can determine if you're profitable is if you use what I'm calling the breakeven budget process. If, after having set aside the necessary funds for all future expenditures, only then can you pay yourself a bonus or take cash out of your business.

The Breakeven Budget process recognizes that having cash on hand does not mean that it can be spent any way you wish. Every business—whether you have thought about it or not—has built-in **future** expenses that must be accounted for on a monthly basis before you can say whether you are profitable.

Here is a simple example of both a cash and accrual process:

Cash vs. Accrual Accounting

EXPENSES	CASH METHOD	ACCRUAL METHOD
REGULAR MONTHLY	X	X
Rent	X	X
Telephone	X	X
Salaries	X	X
Entertainment	X	X
Car Payments	X	X
Insurance Premiums	X	X
Gasoline	X	X
REGULAR NON-MONTHLY	I	X
Annual License Fees	I	X
Professional Dues	I	X
Subscription	I	X
Insurance Premiums	I	X
Estimated Federal and State Taxes	I	X
Meals, Entertainment	I	X
Gifts	I	X
Marketing Expenses	I	X
Retirement Plan Contributions	I	X
EE Bonuses	I	X
VARIABLE EXPENSES	I	X
Business Trips	I	X
Office Redecorating	I	X
Stationary	I	X
Equipment Repairs	I	X

X: Money set aside or paid monthly

I: Only paid when actually due

The Breakeven point: when all expenses are paid or funds have been set aside to cover future expenses.