

## 9.7: Budget Preparation

### Learning Objectives

- Describe each decision of budget preparation

During budget preparation, the retail manager needs to ask and answer the following questions:

1. What are the expected sales for this time period?
2. How much merchandise on hand will be needed to produce the projected sales?
3. How much and when will price reductions need to be taken in order to dispose of merchandise to generate sales and revenue?
4. What additional merchandise purchases will be needed during the season?
5. What gross margin dollars and percent will be needed to achieve the desired profit?

On the face of it, these aren't especially difficult questions to answer.

1. Perhaps we'd estimate that sales continue at the same rate that they did in the previous time period. Or, perhaps, we project that they'll exceed last year's (LY's) sales levels by a certain percent (+x%). Or, it's possible that we'd expect a given item to perform similarly to another.
2. If we have a fair understanding of expected sales (revenue) and the average selling price, we can easily determine inventory needs.  $\text{Inventory} = \text{sales revenue} / \text{average selling price}$
3. This one is a bit more complex, but you'll notice that in point #2, we didn't divide sales revenue by retail price. Instead, we used "average selling price." This conveys that we don't expect to sell all items at full price. Rather, some portion of our inventory will be discounted to accelerate turns and reduce inventory (risk). Looking at past data, a retail manager may know what portion or percent of a product's inventory will be discounted to ensure there isn't remnant inventory. Further, they may have good information about when decisions to reduce prices should occur. Lacking appropriate historical references, a retail manager will have to monitor these decisions more closely.
4. This is a question of "What if?" What if we don't have enough cash on-hand to order the full inventory need to meet our revenue goals? When will we need to re-order product? What if the product is far more successful than we expected and we'll exceed our revenue goals? Will we be able to place more orders? Will they arrive in time to capitalize on the opportunity?
5. As you saw earlier, gross margin dollars and gross margin percent are easily calculated.
  1.  $\text{Gross margin dollars} = \text{selling price} - \text{cost of goods}$
  2.  $\text{Gross margin percent} = (\text{selling price} - \text{cost of goods}) / \text{selling price}$

Where this gets much, much more difficult is understanding "how much will be needed to achieve the desired profit?"

The challenge for a business is to build a budget that provides for the financial health of the company. That is, a budget that generates sufficient revenue to cover operating expenses, while also returning profit for reinvestment in the company or distribution to the owners in the form of cash payouts (dividends). Thus, the above questions take on heightened importance because they directly impact the financial health and future of the company.

If sales fall below budget projections, then there isn't enough positive cash flow (income greater than expenses) to cover all operating costs or provide for reinvestment in the business. In this event, the firm risks several outcomes, such having to forgo important investments in the business that would spur future growth while its competitors move ahead or being forced to borrow funds to cover its performance miss, meaning that some future cash flow will be required to pay back the loan, including interest. It also may have to reduce costs, possibly including labor or marketing, leaving people laid-off and promotions less effective than competition, respectively.

As you might assume, those are not good situations for the firm to find itself. Thus, the budgeting process becomes critically important to ensure the financial health and future of the company.

### Practice Questions

<https://assessments.lumenlearning.co...sessments/9242>

## Video -- Spotlight on the Difference between Budgeting and Forecasting



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