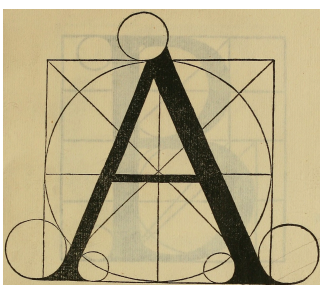




9

BUDGETING & CASH FLOW FORECASTING

Accounting and budgeting compared



From *Divina proportione*, by Leonardo da Vinci, 1509, Wikimedia Commons (<https://commons.wikimedia.org/>). In the public domain.

Accounting is a function that relates to all other aspects of the business in some respect. Where financial implications of business decisions are documented, accounting principles and standards determine how, if and when financial information is recorded and presented. These principles and standards are actively enforced by the various agencies and bodies,

primarily due to their direct relevance to and impact on accurate income tax assessment. As discussed in preceding chapters, financial accounting involves producing reports to disclose the financial position and performance of the entity in a manner that is useful externally. Management accounting involves producing reports to disclose the financial position and performance of the entity in a manner that is useful internally. The concept of the budget becomes relevant in the context of the latter.

Budgeting key concepts

On first approaching the concept, a **budget** may be interpreted as either an allotment of money assigned for a specific purpose, or as an estimate of costs to be incurred in pursuit of a particular business opportunity. A budget is also a road map for planning, organising and controlling business resources, and as such functions as a vital component of the strategy of even the smallest of creative businesses. Bookkeeping processes provide a means of recording accounting events past and present, whereas budgeting is concerned with assigning and managing business resources for the future. As management accounting does not involve reporting to parties external to the entity, the financial information recorded and presented in the course of carrying out budgeting activities is not subject to the rigorous oversight of the AASB. Therefore, some flexibility can be afforded in the way budgets are structured, presented and used. There are a number of advantages and disadvantages to consider in carrying out budgeting activities:

ADVANTAGES	DISADVANTAGES
Formalises the process of setting targets	Based largely on assumptions
Provides a point of comparison for future projects	Risks associated with overestimating revenues
Prompts constant reevaluation of expenditure	Risks associated with underestimating expenses

Consider the following example of a simple project budget for a film scoring session:

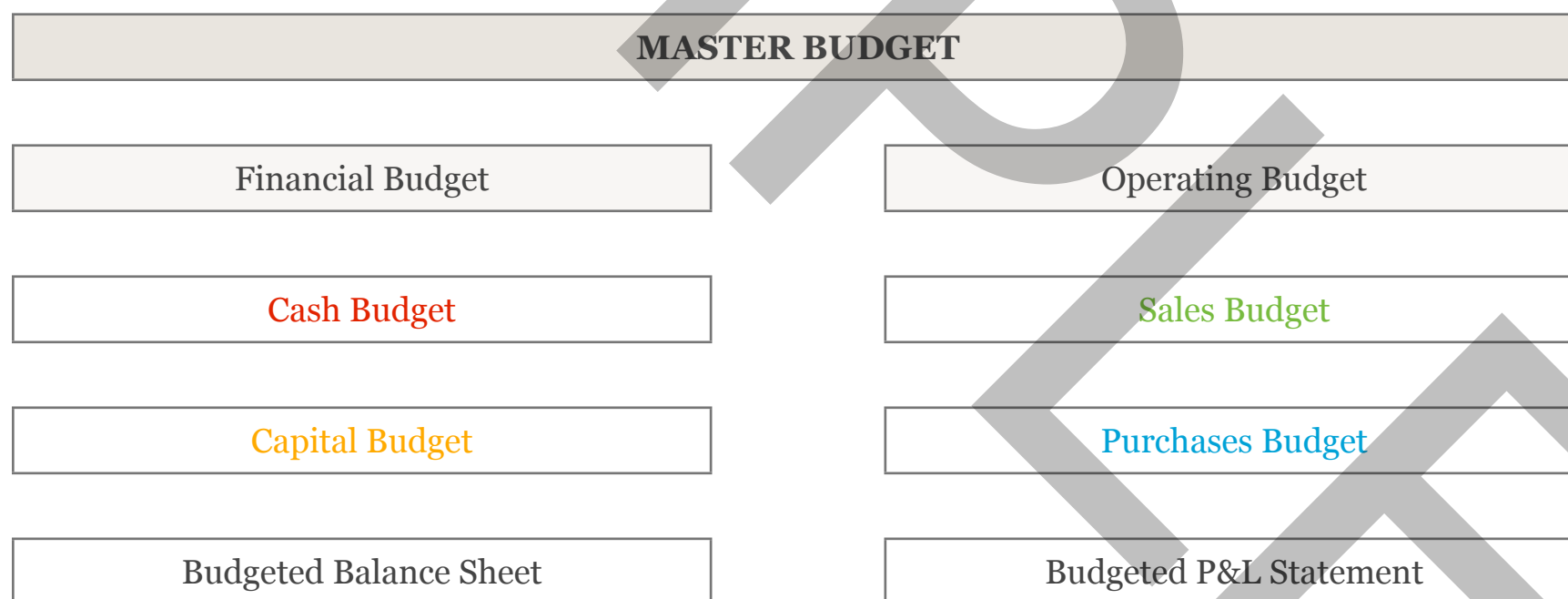
EXPENSE	RATE	HOURS	DAYS	TOTAL
Equipment	\$200	7	6	\$8,400
Performers	\$135	5	5	\$3,375
Special Performers & Soloists	\$185	5	3	\$2,775
Engineers (Session & Post)	\$100	7	8	\$5,600
			TOTAL	\$20,150

Consider the following example of a simple project budget for a street art installation:

EXPENSE	PER UNIT COST	VOLUME	TOTAL
Fabrics & Materials	\$45	102	\$4,590
Canvases & Paints	\$85	35	\$2,975
Lighting Components	\$14	86	\$1,204
Installation Licence	\$485	1	\$485
		TOTAL	\$9,254

Master budget

A **master budget** comprises detailed forecasted financial information relating to sales, purchases, **revenues** and **expenses** over a particular time frame (usually 12 months). The process of continuous budgeting involves adding one month to the master budget as each month elapses. The master budget comprises the financial budget and the operating budget. Consider the following table to assist in understanding the components of the master budget:



A budgeted Balance Sheet and budgeted P&L Statement are functionally and visually similar to those that appeared in the preceding chapter except the figures are forecasted, based on predicted events, as opposed to recorded, based on historical events.

Worked Example

An Italian art auction house and museum is holding a budget meeting. The curator, accountant and a feature artist attend the meeting to plan events for July to September 2020, one of which is a major exhibition beginning in August. The accountant brings a number of master budget components to the meeting including a cash budget, sales budget and purchases budget.

CASH BUDGET			
<i>Il Museo Marieschi</i>			
<i>For July to September, 2020</i>			
	July	August	September
Opening cash balance	\$15,000	\$10,000	\$20,000
Target closing balance	\$10,000	\$20,000	\$5,000
Available cash balance	\$5,000	\$0	\$15,000
Operating Activities			
Cash Sales	\$56,000	\$76,000	\$77,000
Cost of Sales Expenses	(\$2,000)	(\$5,000)	(\$3,000)
Gallery Staff Wages Expenses	(\$36,000)	(\$50,000)	(\$45,000)
Public Liability Insurance Expenses	(\$5,000)	(\$8,000)	(\$5,000)
Specialised Transportation Expenses	(\$17,000)	(\$8,000)	(\$14,000)
Cash flows from (used in) Operating Activities	(\$4,000)	\$5,000	\$10,000
Target surplus (deficit)	\$1,000	\$5,000	\$25,000
Financing Activities			
Short-term Loan Payable CR	\$9,000	\$20,000	\$0
Short-term Loan Payable (DR)	\$0	\$5,000	\$20,000
Cash flows from (used in) Financing Activities	\$9,000	\$15,000	(\$20,000)
Closing cash balance	\$10,000	\$20,000	\$5,000

A cash budget is functionally and visually similar to the Statement of Cash Flows that appeared in a preceding chapter except the figures are forecasted, based on predicted events, as opposed to recorded, based on historical events. Using horizontal analysis, the preceding budget can be evaluated to provide an understanding of how the business intends to plan, organise and control cash-related activities. For example:

- a) Note the planned increase in the **expense** account *Gallery Staff Wages Expenses* during the major exhibition.
- b) Note the planned increase in the **expense** account *Specialised Transportation Expenses* prior to and following the major exhibition.
- c) Note the planned increase in the **liability** account *Short-term Loan Payable* prior to the major exhibition and planned decrease following the major exhibition.

SALES BUDGET			
<i>Il Museo Marieschi</i>			
<i>For July to September, 2020</i>			
	July	August	September
<i>Artwork Sales Commissions</i>	\$15,000	\$7,000	\$34,000
<i>Gallery Gift Shop</i>	\$3,000	\$9,000	\$6,000
<i>Gallery Tours</i>	\$3,000	\$5,000	\$4,000
<i>Ticketing</i>	\$35,000	\$55,000	\$33,000
Total Income	\$56,000	\$76,000	\$77,000

A sales budget is functionally and visually similar to components of the P&L Statements that appeared in preceding chapters except the figures are forecasted, based on predicted events, as opposed to recorded, based on historical events. Using horizontal analysis, the preceding budget can be evaluated to provide an understanding of how the business intends to plan, organise and control sales-related activities. For example:

- a) Note the planned increase in the **revenue** account *Artwork Sales Commissions* following the major exhibition.
- b) Note the planned increase in the **revenue** account *Gallery Gift Shop* during the major exhibition.

c) Note the planned increase in the **revenue** account *Ticketing* during the major exhibition.

PURCHASES BUDGET			
<i>Il Museo Marieschi</i>			
<i>For July to September, 2020</i>			
	July	August	September
Purchases	\$1,000	\$2,500	\$1,500
Freight Inwards	\$500	\$2,000	\$1,000
Inventory Adjustments	\$500	\$500	\$500
Total Cost of Goods Sold (COGS)	\$2,000	\$5,000	\$3,000

A purchases budget is functionally and visually similar to components of the P&L Statements that appeared in preceding chapters except the figures are forecasted, based on predicted events, as opposed to recorded, based on historical events. Using horizontal analysis, the preceding budget can be evaluated to provide an understanding of how the business intends to plan, organise and control purchases-related activities. For example:

- a) Note the planned increase in the **cost of sales** account *Purchases* during the major exhibition.
- b) Note the planned increase in the **cost of sales** account *Freight Inwards* during the major exhibition.

Cash flow forecasting

The process of estimating future cash inflows and outflows based on predicted events is referred to as **cash flow forecasting**. A cash flow forecast projects **revenues** and **expenses** over a given time period (usually 12 months). Managers may undertake forecasting regularly in the course of operating a creative business or on an ad hoc basis. A cash flow forecast should be updated during the course of the operating cycle as unplanned events unfold. Projections should take sales history, market trends and industry competition into account to ensure a reliable estimate can be made.

Worked Example

A folk and world music festival is being held in Daylesford, Victoria later this year. The five festival managers are holding a budget meeting, during which a cash flow forecast will be drawn up to outline how the managers intend to plan, organise and control cash-related activities. Management discuss the implications **revenues** and **expenses** are expected to have on the cash flow forecast. Consider the following **revenue** items:

- a) The festival is being held over 3 days on a long weekend.
- b) The RRP ticket price for adult and concession tickets is \$49 and \$39 respectively. Last year 2,000 adult and 1,500 concession tickets were sold. Sales are expected to increase by 20% this year.
- c) The RRP for a backstage pass is \$89 in addition to the ticket price. It is expected that 5% of ticket holders will purchase this pass.
- d) Festival vendors* are expected to sell \$12,500 in food and \$14,500 in drink daily.
- e) Merchandise vendors* are expected to sell 4,000 hats for \$60,000 and 1,500 t-shirts for \$45,000.
- f) There are two sponsors for the festival, each contributing \$10,000 in **revenues**.

Consider the following **expense** items:

- a) **Cost of sales** is \$25,500 for food, \$28,500 for drink, \$25,000 for hats (merchandise) and \$18,000 for t-shirts (merchandise) for the weekend.
- b) 50 adult tickets are provided for sponsors (sponsors are not considered punters).
- c) The bands on the set list are taking fees of 10% of ticket sales for their appearance.
- d) The local council is charging fees of \$60,000 to hire the space for the weekend.
- e) Lighting and sound engineers are charging fees of \$80,000 for labour and rental.
- f) The promoters are taking fees of 30% of merchandise sales for marketing services.
- g) Security contractors are charging fees of \$36,000 for the weekend.
- h) The ticketing agency is taking fees of 5% of ticket sales for ticketing services.

Consider the following items relating to the closing cash balance:

- a) Each festival manager is taking 4% of the closing cash balance.
- b) The owners of the firm operating the festival are taking 12%.
- c) The owners are also donating 6% of the closing cash balance to charity.

*Vendors are owned by the festival, and their sales comprise its **revenues**

Consider the following cash flow forecast:

CASH FLOW FORECAST				
<i>Saxonmead Folk Festival</i>				
2020				
	Quantity	Unit Value	Line Item Value	Total Value
Revenues				
Ticket Sales				
Adult Tickets	2,400	\$49	\$117,600	
Concession Tickets	1,800	\$39	\$70,200	
Backstage Passes	210	\$89	\$18,690	
Total Ticket Sales				\$206,490
Food & Drink Sales				
Food	3 Days	\$12,500 Daily	\$37,500	
Drink	3 Days	\$14,500 Daily	\$43,500	
Total Food & Drink Sales				\$81,000
Merchandise Sales				
Hats	4,000	\$15	\$60,000	
T-shirts	1,500	\$30	\$45,000	
Total Merchandise Sales				\$105,000
Total Income				\$392,490
Cost of Goods Sold (COGS)				
Food & Drink COGS				
Food	3 Days	(\$8,500) Daily	(\$25,500)	
Drink	3 Days	(\$9,500) Daily	(\$28,500)	
Total Food & Drink COGS				(\$54,000)
Merchandise COGS				
Hats	4,000	(\$6.25)	(\$25,000)	
T-shirts	1,500	(\$12)	(\$18,000)	
Total Merchandise COGS				(\$43,000)
Total Cost of Goods Sold (COGS)				(\$97,000)
Sponsor Donations				
Sponsor Donations	2	\$10,000		\$20,000
Gross Profit & Donations				\$315,490
Sponsor Tickets				
Sponsor Tickets	50	(\$49)		(\$2,450)

Expenses		(Cost Per Punter*)		
Band Appearance Expenses		(\$4.92)	(\$20,649)	
Council Hire Expenses		(\$14.29)	(\$60,000)	
Lighting & Sound Expenses		(\$19.05)	(\$80,000)	
Marketing Expenses		(\$7.50)	(\$31,500)	
Security Expenses		(\$8.57)	(\$36,000)	
Ticketing Expenses		(\$2.46)	(\$10,324.50)	
Total Expenses				(\$238,473.50)
Closing cash balance				\$74,566.50
Net Profit Deals**		Unit Value		
Managers' cut	5	\$2,982.66	\$14,913.30	
Owners' cut			\$8,947.98	
Total Net Profit Deals				\$23,861.28
Cash donations				\$4,473.99

*Note: based on 4,200 punters attending

Net profit deals in the context of cash flow forecasting should be interpreted independently of **net profit (loss) terminology defined in preceding chapters such as **EBITDA** and **NPAT**. In these instances, net profit deals simply refer to the cash returns negotiated by the entity's stakeholders, and carry subsequent taxation obligations

Comparing budgets, forecasts and accounting methods

Budgeting involves quantifying financial targets and formulating financial plans, whereas forecasting involves projecting the likely outcomes of the entity's financial dealings, irrespective of targets and plans. Both provide managers with an understanding of the intricacies of expected future financial dealings, and with the estimated closing cash balance at the conclusion of each future period. These activities provide managers and accountants with the opportunity to pre-empt any hinderances on cash flow, and instigate course correction if necessary. The complexity of both master budgets and cash flow forecasts are heavily dependant on the accounting method a business uses. Inherently, cash basis accounting is more compatible with the concept of budgeting due to the fact that it tracks cash transactions (i.e., **revenues** and **expenses**) easily and effectively. Inversely, a

business using accrual basis accounting will often carry out budgeting activities in line with cash inflows and outflows, rather than **revenues** and **expenses**.

Music industry budgets and royalties

Music businesspeople employ a unique set of terminology inapplicable to the broader disciplines of accounting, budgeting or business management. Unlike much of the terminology defined in preceding chapters, the connotations of these terms may vary contextually and, perhaps to a greater extent, according to the mutual understanding of their effect by all parties involved in the transaction. Artists, label managers, music managers, publishers and music business accountants will utilise these terms in carrying out budgeting activities or in drawing up contracts.

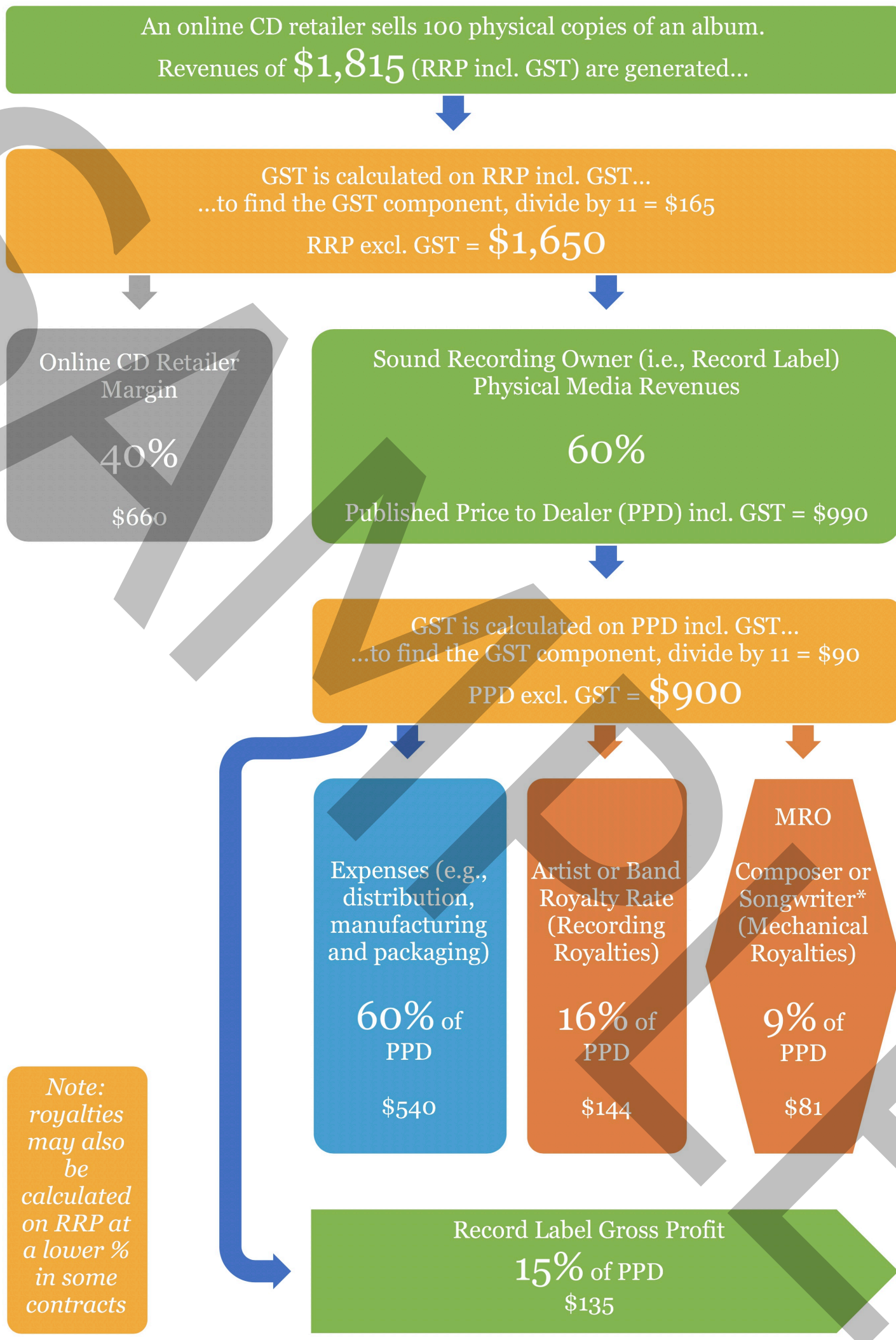
Royalties are the **revenues** that parties will receive in exchange for their work on a creative project and for ongoing use of their IP. There are a number of different types of entity involved in the process of collecting and distributing royalty income. These entities include:

- a) The sound recording owner (e.g., the film studio, record label or self-release artist): manages recording royalty distribution when a sound recording is sold or streamed.
- b) The performance rights organisation (PRO): manages performance royalty distribution when a musical work is performed. There is a specific PRO for Australia and New Zealand (<https://apraamcos.com.au/>).
- c) The mechanical rights organisation (MRO): manages mechanical royalty distribution when a musical work is sold or streamed. There is a specific MRO for Australia and New Zealand (<https://apraamcos.com.au/>).

Each of these entities, as well as the artists, bands, composers or songwriters and publishers, are entitled to a percentage of **revenues** each time music is performed, sold or streamed. Recording artists and bands are not entitled to performance or mechanical royalties (unless they are also the songwriters). Instead, they receive recording royalties (i.e., an artist royalty rate) from labels as a percentage of physical sales, digital sales or streaming **revenues** as specified in their contract.

Consider the following graphic to assist in understanding how physical media **revenues** may be calculated for a record label:

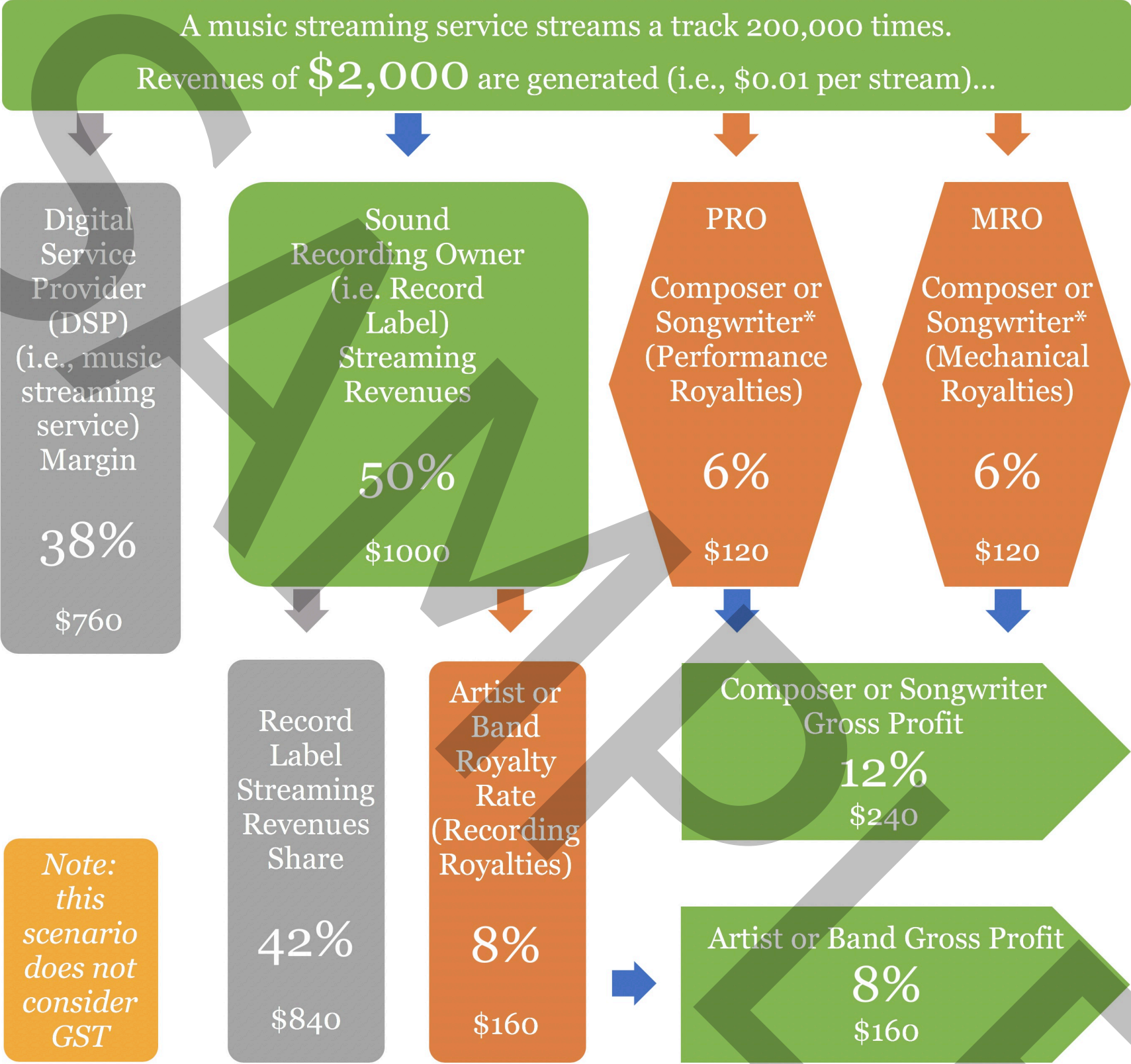
FIGURE 9.1



Physical media revenues and royalties

Consider the following graphic to assist in understanding how music streaming **revenues** may be calculated for a signed artist or band and composer or songwriter:

FIGURE 9.2



Streaming revenues and royalties

*Note: both scenarios assume the composer or songwriter is the publisher. If there was a publishing contract to consider, the publisher would also be entitled to a share

In a typical record deal, artists are paid an artist royalty rate based on a percentage of **revenues** attributable to the sound recording (e.g., 16%). In a net profit deal, artists are

paid a percentage of **Net Profit (Loss)** attributable to the sound recording (e.g., 50%). The latter provides the record label with an opportunity to recover all related **expenses** (e.g., distribution, manufacturing, packaging, recording and wages) before making any payments to the artist. Depending on the contract, there may be a number of other **expenses** the record label is entitled to recoup such as administration or overhead fees. A self-release artist is entitled to all **revenues** generated as the sound recording owner, but will forgo a number of benefits that would otherwise be afforded to an artist signed to a record label. A self-release artist:

- a) incurs all related **expenses** (e.g., distribution, manufacturing and packaging); and
- b) usually does not possess the same marketing or networking abilities as a label; and
- c) is occupied full time by the business and not with their creative endeavour.

The contractual and legal entitlements and obligations of entities engaged in, or intending to engage in, earning **revenues** from royalties vary greatly. For this reason, the aforementioned scenarios should be considered hypothetical. In practice:

- a) different percentage **revenues** may be payable to the entities and parties; or
- b) there may be additional or fewer parties involved than those discussed here; or
- c) a deal may be structured entirely differently rendering these scenarios incomparable as a result (i.e., **revenues** and **expenses** earned and incurred in a different order, in different proportions or at different times); or
- d) taxation implications may be calculated and interpreted differently.

Other budgeting considerations for creative businesses

In the creative industries, the vast majority of businesses operate as sole proprietorships or partnerships. In larger businesses, employers are required to set aside a super guarantee (SG) contribution to be paid to all employees' (casual, part-time and full-time) superannuation funds in addition to agreed wages or salary. The SG contribution:

- a) must be paid if an employee earns “\$450 or more in a calendar month; and
- b) is currently 9.5%* of an employee’s ordinary time earnings; and
- c) must [be paid] at least four times a year, by the quarterly due dates” (ATO, 2020d).

*Note: expected to increase to 12% by 2025

These payments are made by the accountant, and are listed on each employee's payslip separate to gross payments. As a creative person in a sole proprietorship or partnership however, this process does not happen automatically. Whilst there is no legal requirement for the self-employed to contribute to super, it is advisable to budget to match the current SG set by the government with the intention of making personal super contributions into a complying fund. Tax deductions can be claimed for contributions made.

A commercial creative enterprise should also be engaged in marketing activity of some form. The amount budgeted for marketing **expenses** varies from business to business, but is often somewhere in the range of 7% to 12% of Total Income. LSOs may budget amounts as high as 40% of Total Income. Creative businesses generally have smaller and more specific target audiences than businesses in other industries such as hospitality, retail or technology. Some of the targeted strategies that a creative business might employ to raise brand awareness include:

- a) engaging in social media marketing or blogging; or
- b) establishing brand partnerships; or
- c) making flyer drops; or
- d) paying for search engine optimisation (SEO); or
- e) setting up poster campaigns.

Budgeting for travel **expenses** is also important for creative people in business. If individuals travel for work, the business must incur the travel **expenses** in order for them to be claimed as a tax deduction. "A sole trader with simple tax affairs can create a logbook and record business-related car trips" (ATO, 2019d). The ATO provides an app that can be downloaded to track:

- a) "the car's odometer readings at the start and end of the logbook period; and
- b) the reason for the journey (business reason or private use); and
- c) start and end date of the journey; and
- d) odometer readings at the start and end of the journey" (ATO, 2019d).



Tip: a sole trader and their business are considered the same entity for tax purposes. Funds can be transferred from the business bank account to a personal account as required. For this reason, sole traders need to budget responsibly.

Consider the following example of a cash flow forecast for a self-release artist that considers royalty income, manufacturing, marketing, superannuation and travel **expenses**:

CASH FLOW FORECAST				
Fireflyica				
For June, 2020				
	Quantity	Unit Value	Line Item Value	Total Value
Revenues				
Record Sales				
Singles	120	\$10	\$1,200	
Albums	80	\$15	\$1,200	
Vinyls	40	\$20	\$800	
Total Record Sales				\$3,200
Digital Sales				
Digital Album Revenues	300	\$10	\$3,000	
Streaming Revenues	150,000	\$0.01	\$1,500	
Total Digital Sales				\$4,500
Other Income				
Mechanical Royalties	240 + 150,000	\$1.20 + \$0.0006	\$378	
Performance Royalties	150,000	\$0.0006	\$90	
Synchronisation Licence	1	\$1,000	\$1,000	
Total Other Income				\$1,468
Total Income				\$9,168
Cost of Goods Sold (COGS)				
Distribution	240	(\$0.50)	(\$120)	
Manufacturing	240	(\$2)	(\$480)	
Mixing & Mastering	30 Hours	(\$100)	(\$3,000)	
Packaging	240	(\$0.25)	(\$60)	
Studio Time	20 Hours	(\$30)	(\$600)	
Total Cost of Goods Sold (COGS)				(\$4,260)
Gross Profit				\$4,908
Expenses				
Giveaways	20	(\$2.25)		(\$45)
Expenses				
		(Cost Per Record*)		
Administration Expenses		(\$0.83)	(\$200)	
Equipment Rental Expenses		(\$2.08)	(\$500)	
Marketing Expenses		(\$2.68)	(\$642)	
Rehearsal Space Expenses		(\$0.42)	(\$100)	

Superannuation Expenses		(\$2.08)	(\$500)	
Travel Expenses		(\$1.67)	(\$400)	
Wages Expenses		(\$10.50)	(\$2,521)	
Total Expenses				(\$4,863)
Closing cash balance				\$0

*Note: based on forecasted sales of 240 units of physical media

Notes and assumptions regarding **revenues**:

- Record sales line items are listed at PPD excl. GST.
- Mechanical royalties are attributed to both physical media **revenues** and streaming **revenues** (i.e., $(\$3,200 \times 9\%) + (\$1,500 \times 6\%)$).
- Performance royalties are attributed to streaming **revenues** (i.e., $\$1,500 \times 6\%$).
- Royalties attributable to digital album **revenues** are not expected this period.
- A film studio intends to license one of the tracks from the album for \$1,000. In future periods, synchronisation royalties will be attributable to this licence.
- Royalty income this period is attributed to similar sales figures from the previous year. In reality, royalty income is not received until some time after it is earned.

Notes and assumptions regarding **expenses**:

- 30 hours of mixing and mastering time is budgeted.
- 20 hours of studio time is budgeted at a discounted hourly rate.
- The per unit cost of giveaways comprises manufacturing and packaging **expenses**.
- Marketing **expenses** are forecasted at 7% of Total Income.
- The majority of the sales mix comprises digital sales. Indeed, Total Income in this case without digital sales would not cover **cost of sales** and **expenses** combined.

This cash flow forecast is an example of zero-based budgeting, a budgeting practice where cash inflows balance cash outflows and all expenditure must be planned for and justified ahead of time. In the example above, as the artist is paying themselves a wage, it is not necessarily concerning that the closing cash balance equals zero. This particularly restrictive form of budget is more suited to project budgets rather than operating budgets. For music industry professionals specifically, there are a number of tour planning software packages available that have budgeting components (e.g., <https://www.eventric.com/>).

Review these questions some time after reading the preceding chapter...



Discussion Questions

- 1. What is the purpose of a budget? How is a budget formatted?*
- 2. What are some of the differences between bookkeeping and budgeting?*
- 3. What does the master budget contain?*
- 4. What is the purpose of a cash flow forecast? How is a cash flow forecast formatted?*
- 5. Cuts or deals made on sales or Gross Profit might present problems for both parties. Why is this so?*
- 6. How do budgets and forecasts differ?*
- 7. How do accounting methods impact budgeting activities?*
- 8. What are some of the challenges associated with budgeting activities involving royalty income?*
- 9. How might a record deal be structured from a budgeting perspective?*
- 10. What considerations do creative people need to take into account when undertaking budgeting activities?*



Activities

To apply your knowledge, find activities for this chapter at
[*afcm.maxpenno.com.au*](http://afcm.maxpenno.com.au)
