Planning for Profit

Editorial

Over the next few months the focus of the newsletter will be Managerial Finance. We will cover a number of methods and techniques that will be of practical value to you either in your role as a Practicing Certified Bookkeeper or in employment as a bookkeeper in business. This month we examine the underpinning knowledge and understanding of the need for and the purpose of Budgetary Control. This theory in the months to follow will be supported by a series of case studies in planning and the analysis of business performance. I hope that these will add to developing your competence in this area and so enhance your CPD.

Dr Philip E Dunn
Editor

Planning for Profit

A budget has been defined as "a plan expressed in money. It is prepared and approved prior to a budget period and may show income, expenditure and the capital to be employed. It may be drawn up showing incremental effects on former budgeted or actual figures, or be compiled by zero-base budgeting technique". (CIMA)

The setting of budgets compel planning: and business planning comprises:

- What does the organisation want to do?
- How best can this be done?

The role of planning is based on a series of set procedures which include:

- Establish the firm's present position.
- Predict future environment.
- Clarify the objectives – which primarily concern improving the return to owners ie improving shareholder value.
- Evaluate alternative courses of action.
- Select the best strategy.
- Prepare plans to implement the strategy.

The short-term plan shows how resources will be acquired and used over a period. Preparing it is known as 'budgeting', using it as a means of controlling activity is termed 'budgetary control'. The budget is a short-term manifestation of a longer-term strategy.

The purpose of budgeting include a number of defined objectives:

- To formulate a short-term plan.
- To provide estimates or requirements of resources: finance, labour, materials and facilities.
- To define normal operating conditions – this is necessary for determining overhead recovery rates.
- To set standards/targets/goals which will motivate.
- To evaluate corporate and departmental efficiency.
- To delegate responsibility for costs to enable management to retain overall control.

In addition to these specific objectives, consideration needs to focus on the concept of control.

Budgeting-Control Aspects

As in other control systems, control is affected by:

- Comparing actual performance with planned
- Calling for explanation of differences variance accounting
- Taking appropriate action

Budgetary Control

"The establishment of budgets relating to the responsibilities of excelutives to the requirements of policy, and the continuous comparison of actual with budgeted results, either to secure by individual action the objectives of that policy or to provide a basis for its revision". (CIMA)

Some control guidelines are:

- Control is attained through people
- Hence need for responsibility centres
- Only controllable costs should be charged
- Every cost is charged to someone
- Reports should be based on exception priorities
- Control should recognise changed conditions

This element of control often involves the use of flexible budgetary control technique.

Flexible Budgets

Budgets are prepared for a 'normal' capacity usage (or activity level).

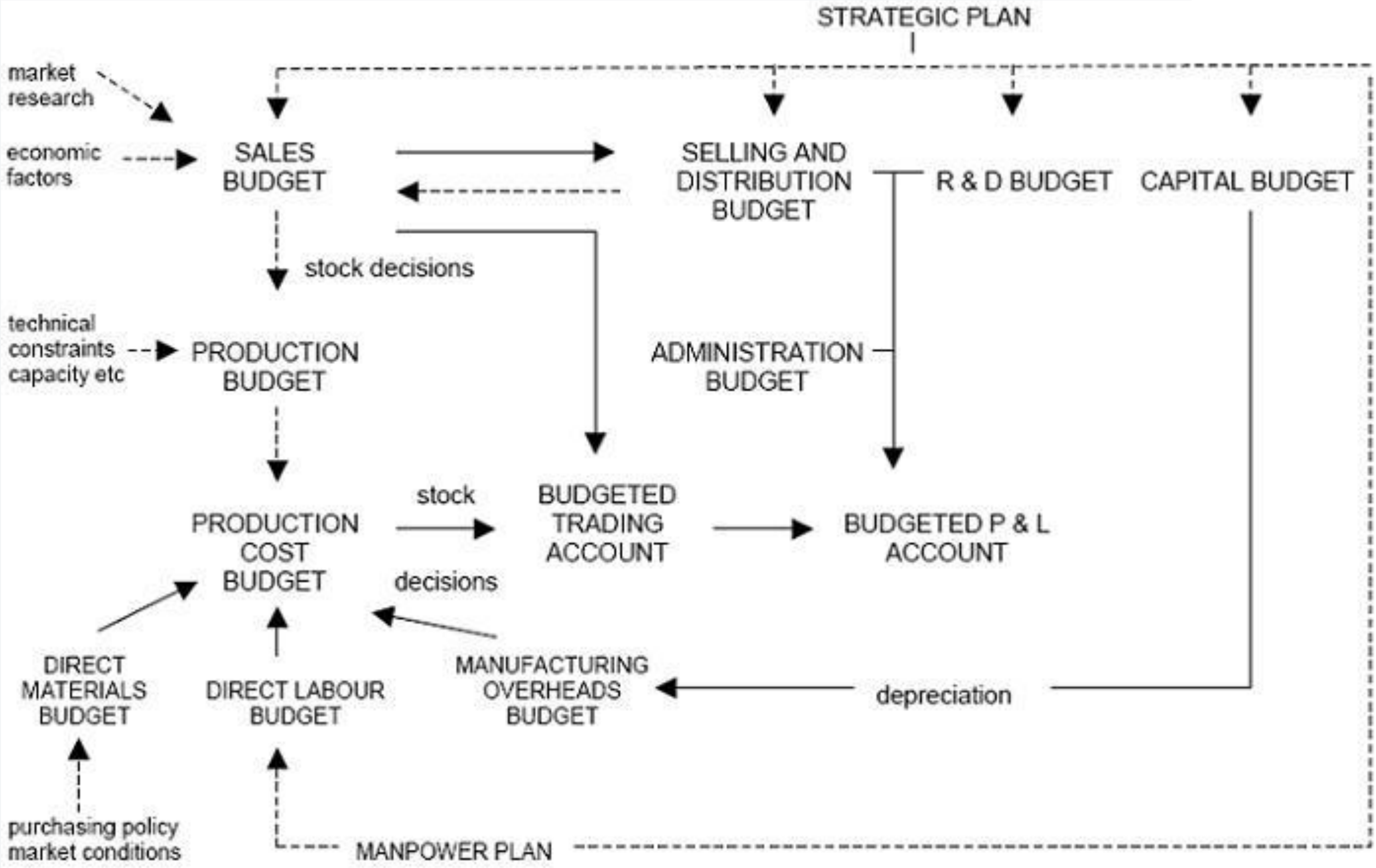
- Where actual capacity usage differs from planned usage, the resultant comparison between actual costs and planned costs may be invalid.
- One approach to problem is to have Flexible budgets, which recognise the difference between fixed, variable and semi-variable costs and enable overhead budgets to be prepared at different levels of activity.
- In preparing control statement, the budget at the appropriate level of activity can now be chosen.

Relevance of Budgetary Control to Managerial Activities

- Requires short-term objective to be clarified.
- Involves planning as a team.
- Provides opportunity for participation.
- Defines/correlates/co-ordinates departmental interests.
- Facilitates delegation – enables 'exception principle' to be applied.
- Provides yardsticks of performance.
- Provides blue-print for:
  Forward buying
  Recruitment/training of labour
  Capital expenditure requirements
  Stock holding/pricing/sales and credit policies
  Cash needs
  Production scheduling/planning

The diagram which follows illustrate the factors which underpin the budgetary process in the profit planning cycle.

Budgets for Profit Planning



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The Preparation of Functional Budgets

At the outset a principal budget factor or limiting factor is identified. This determines scale; examples include sales volume, available finance or productive capacity.

Sales Budget

This calls on the market and consumer research information available to the firm and includes:

- Market surveys
- Representatives' estimates and opinions
- Pricing structures and policy
- Advertising policy
- Target market share

The sales budget would be in terms of volume and value.

Production Budget

This is based on a number of decisions which include:

- What is to be produced?
- How much is to be produced?

- What delivery is required?
- What are the size of the production runs?

In turn these prior decisions together with expected sales and planned stock level changes would determine the volume of production for each product within the range.

In addition detailed production plans, material and operations schedules would be produced. From this production overview budgets for material usage and cost, labour utilisation, overhead and resource capacity would generate.

Labour Budget

This stems from the production budget as planned production volume can be expressed in terms of standard hours.

The hours would then be matched with standard rates of pay for each grade of labour, together with levels of planned efficiency, and the budgeted labour cost for the period would result.

Materials Budget

This also stems from the production budget, where products are standardised, aggregating material schedules will indicate precise requirement for each type of standard material. Where products are 'one offs' detailed material specifications would also be produced.

The materials budget would show detail of usage and cost. This would be based on standard or planned usage, valued at standard prices.

Plant Utilisation Budget

This is directly linked to the production budget and concerns balancing machine and resource capacity to production requirements.

Factory Overhead Budget

Preferably presented in marginal costing format, by identifying both fixed and variable elements of cost as this enables controllable costs to be distinguished from those which are outside the managers' span of control.

Administration, Selling and Distribution Overhead Budget

This details main areas of the administrative and distribution function and their cost to support, in an effective manner, the 'value added' activities of the business.

Rolling Budgets:

- A continuous (rolling) budget has been defined as 'a budget continuously updated by adding a further period, say a month or quarter and deducting the earliest period'. Procedure is 'beneficial where future costs and/or activities cannot be forecast reliably'.

Advantages of Rolling Budgets

- Reduce the element of uncertainty in budgeting. Concentrate detailed planning and control on short-term prospects where the degree of uncertainty is much smaller.
- Force managers to reassess the budget regularly in the light of current events and expectations.
- Planning and control will be based on a recent plan instead of a fixed annual budget made months previously, which may no longer be realistic.
- Realistic budgets are likely to have a better motivational influence on managers.