

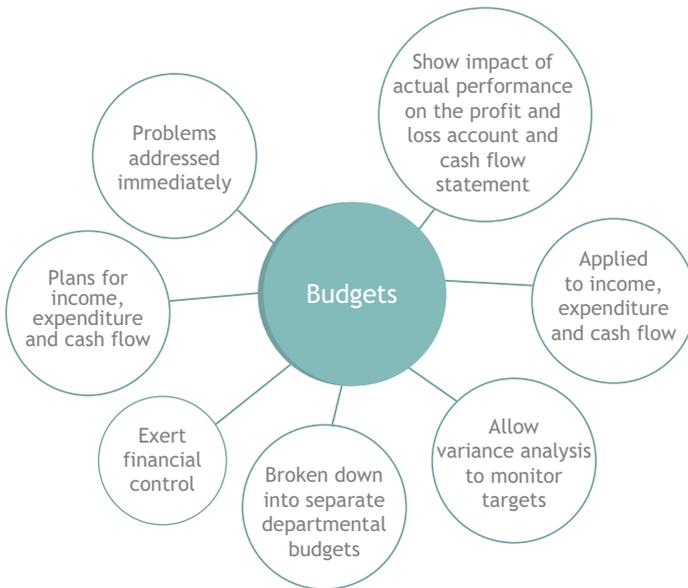


Chapter 14

Drawing Up a Departmental Budget

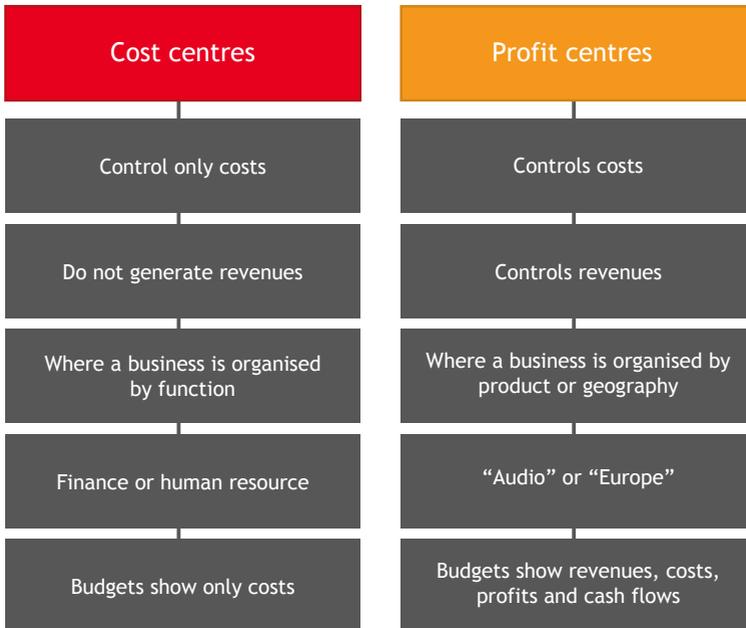
How do I draw up a budget for my department, and monitor it with variance analysis to exert financial control?

Budgets set out plans for income, and expenditure and cash flow, that allow organisations to exert financial control and meet their objectives. Larger organisations will often break down their overall budgets into separate departmental budgets for each department, or responsibility centre. Your departmental budget will allow you to use variance analysis to monitor whether you are meeting your targets for income, and expenditure and cash flow, and to see, on a monthly basis, what effect any variances may have on your department's profit and loss account and cash flow statement. You can then address any problems as soon as they arise, and immediately use information and engage in analysis to ensure that above-target performance continues.



Some departments are called cost centres, because they control only costs, and do not generate revenues. Cost centres occur where a business is organised by function, for example production finance or human resources. Their budgets show

only costs. Other departments are known as profit centres, because they control both costs and revenues. Profit centres occur where a business is organised by product or geography, for example the audio division or “Europe”. Their budgets show costs, revenues, costs, and profits and cash flows.



To draw up the budget for a profit centre, we start with the profit and loss account and list the monthly targets for sales revenues. Department X will set out its budgeted sales for mobiles phones on one line, and its budgeted sales for headphones on another. This will allow its manager to analyse the profitability of each product separately. It will then list the targets for the direct costs of making the phones and headphones, which might include electrical components, plastics and engineers. Adding up these direct costs of production will give the cost of goods sold for each product. By taking each products' sales, and subtracting its cost of goods sold, department X will calculate the monthly gross profit it will target for each product.

Department X - Budgeted Profit and Loss Account			
	£		
	Jan	Feb	Mar
Mobile phones			
Sales	30 000	40 000	42 000
Direct costs			
Electrical components	(5 000)	(8 000)	(9 000)
Plastics	(1 000)	(2 000)	(2 000)
Engineers	(8 000)	(8 000)	(8 000)
Cost of goods sold	(14 000)	(18 000)	(19 000)
Gross profit	16 000	22 000	23 000
Headphones			
Sales	8 000	10 000	11 000
Direct costs			
Electrical components	(1 500)	(2 000)	(2 200)
Plastics	(500)	(700)	(700)
Engineers	(2 000)	(3 000)	(3 000)
Cost of goods sold	(4 000)	(5 700)	(5 900)
Gross profit	4 000	4 300	5 100
Overheads			
Marketing	(8 000)	(8 000)	(8 000)
Legal	(5 000)	(5 000)	(5 000)
Depreciation	(2 000)	(2 000)	(2 000)
Total overheads	(15 000)	(15 000)	(15 000)
PBIT	5 000	11 300	13 100
Interest	(1 000)	(1 000)	(1 000)
Taxation	(2 000)	(2 000)	(2 000)
Net profit after tax	2 000	8 300	1 000

It is up to each business to decide how they wish to treat overhead costs in their departmental budgets. They could simply ask each department to take away their share of the business' total overheads, for example depending upon how much of the marketing or legal support services that department uses. In this case, overheads would appear next in the budget, and the department's total overheads would then be calculated. Alternatively, they could account for overheads in more detail and apportion the overheads to each product separately, depending upon how much of the marketing or legal support services each product uses (for example using activity based costing). So if selling mobile phones uses a much greater share of the department's marketing and legal services, then the overhead costs for mobile phones would be greater, and would be shown separately to the overhead costs for headphones, which would have lower costs in the budget. This might give a more accurate indication of the profitability of each product, but also makes the budgeting process more complicated. We will stick with the simpler approach.

Department X - Budgeted Profit and Loss Account			
	£		
	Jan	Feb	Mar
Mobile phones			
Sales	30 000	40 000	42 000
Direct costs			
Electrical components	(5 000)	(8 000)	(9 000)
Plastics	(1 000)	(2 000)	(2 000)
Engineers	(8 000)	(8 000)	(8 000)
Cost of goods sold	(14 000)	(18 000)	(19 000)
Gross profit	16 000	22 000	23 000
Gross profit	4 000	4 300	5 100
Overheads			
Marketing	(6 000)	(6 000)	(6 000)
Legal	(4 000)	(4 000)	(4 000)
Depreciation	(1 500)	(1 500)	(1 500)
Total overheads	(11 500)	(11 500)	(11 500)

By calculating gross profit, minus, overheads, we get the department's budgeted profit before interest and tax, or PBIT. Adding lines for interest and taxation, then allows the target monthly net profit after tax to be worked out.

After completing the department's budgeted profit and loss account, department X can then draw up its budgeted cash flow statement. It will start by looking at the operating cash flows that are associated with producing and selling its products. It will list its targeted sales revenues from mobile phones and headphones, before calculating total cash receipts. It will then list its budgeted payments for materials, staff and overheads, before calculating total cash payments. By taking total operating receipts, and subtracting total operating payments, department X then calculates its net operating cash flow.

Department X - Budgeted Profit and Cash Flow		£		
	Jan	Feb	Mar	
Headphones				
Sales	8 000	10 000	11 000	
Direct costs				
Electrical components	(1 500)	(2 000)	(2 200)	
Plastics	(500)	(700)	(700)	
Engineers	(2 000)	(3 000)	(3 000)	
Cost of goods sold	(4 000)	(5 700)	(5 900)	
Gross profit	4 000	4 300	5 100	
Overheads				
Marketing	(2 000)	(2 000)	(2 000)	
Legal	(1 000)	(1 000)	(1 000)	
Non-cash expense	(500)	(500)	(500)	
Total overheads	(3 500)	(3 500)	(3 500)	

In the next section, department X will budget for any cash it will need to invest as capital expenditure or Capex, to buy physical assets, such as, new equipment, or to build non-physical assets, such as its brand. It will then add these to give total investing cash flows. By subtracting its total investing cash flows from its net operating cash flow, department X will calculate its net cash flow to show the planned increase or decrease in its cash balance.

Any negative cash balances in department X's budget, will show the amount of financing it will need from the rest of the organisation.

Once the budget has been drawn up, the monthly targets can then be monitored with variance analysis. At the end of each month, a column for comparison between a column for actual and budgeted performance can be compared in columns side by side. A third column should also be inserted in which the variances will be calculated, to show the differences between the targeted and actual figures.

Remember that favourable variances are positive, and show performance that is better than planned.

For example, in January, sales of mobile phones were £10,000 above target. Adverse variances are negative, and show performance that is worse than target. For example, the cost of electrical components for mobile phones was £2,000 over budget.

Drawing up a departmental budget and regularly carrying out variance analysis, allows the manager to exercise financial control by identifying and addressing, poor sales performance and escalating costs at an early stage, before longer-term objectives are missed.

