FINANCIAL TIMES

Essential Guides

BUDGETING AND FORECASTING

HOW TO DELIVER ACCURATE NUMBERS

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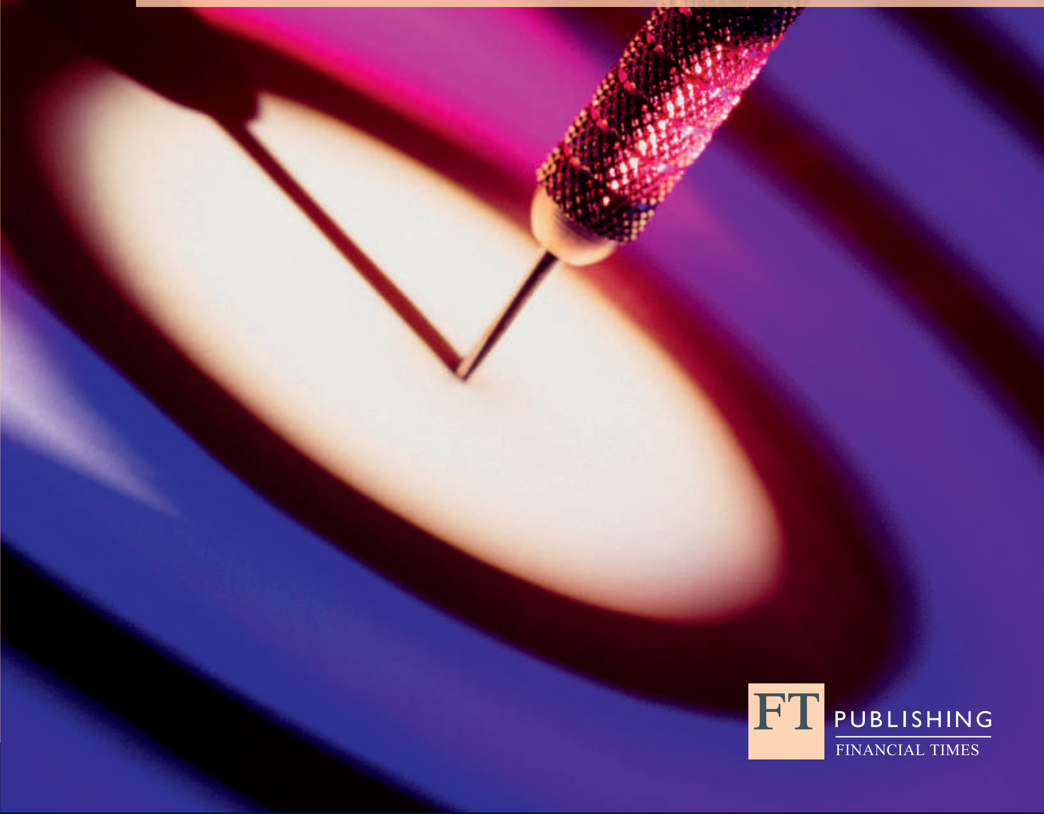

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The Financial Times Essential Guide to Budgeting and Forecasting

Similarly, when we make our purchases with our budgets at work, we should not make our decisions purely based on the costs as there may be factors that mean the cheapest is not the best. Our purchase should not be based on the cheapest option, but the 'best value for money' option: the option that gives us the most for our money. To define what good 'value for money' is we not only need to know the costs, we also need to be able to make a judgement about the value of what we are purchasing. We should make our choices based on what meets our needs most cost effectively.

We may make savings in staff costs by employing fewer staff or recruiting less skilled or less experienced staff on lower rates of pay. This may affect an important aspect of customer service and our savings may be counterbalanced by reduced sales. When managers are given a budget they have to make their judgements based on the costs and the consequences of making savings or spending more.

Exercise

Take a few minutes to think about a purchasing or cost saving decision from your own organisation where money was saved at the expense of customer service or something similar (you can include internal customers in your consideration).

When we are making cost savings we have to start with what is important, what must be preserved and what can be discarded. Your judgements should consider both cost and value. To be a good budget manager you need to understand the cost of everything *and* the value of everything.

Accruals, cash and commitment accounting and budgeting

This section covers financial statements and accounting principles. If you are already expert in this area you could skip through it, though you may still find the material useful for coaching your team or other colleagues. If you are not an expert you will benefit from working through the exercises and examples. You should also feel comfortable about asking for explanations from your finance colleagues – they are there to help and support you.

When we work with small businesses we often find owners and directors confused by financial statements produced by their external firms of accountants. If your accountants are not producing reports and information that are useful to you they are not doing their job. Taking the accounting 'in-house' will probably help some business owners improve their understanding.

Non-accountants often get confused between the differences in cash, profits ('accrual based') and commitments. In most organisations the accounts are produced on an accruals basis. This means that income is recorded as it is earned; this is when we supply goods and services. Costs are recorded when we receive the benefits from those costs (this concept is explained further with examples later in this chapter).

When we order goods and services we may well record these in our accounts as a commitment. If you do not have a sophisticated finance system you could just record these in a spreadsheet or an accounts book. Monitoring your commitments (rather than just your expenditure) and what you have left to make decisions over can be a useful approach to staying within a budget. If you do this, try to think about expenditure which might not be recorded as a commitment yet is effectively committed, such as future staff pay and contracted services.

Profit is a measure of performance and in many organisations it is the only measure of performance. Profit is the amount which has been earned less resources consumed over a period. Profits are accounted for on an accruals basis; this means there will be a difference between the budget for profit and the budget for cash. It also means that a business can be profitable and run out of cash (or go bankrupt) and yet a loss-making business can still generate cash and stay in business.

Costs

Example 1

Rex Retail Limited operates a number of shops across the country. Each shop has a manager with full budget responsibility. Every month the managers review their branch profit and loss account (known as the P&L). The rental charge is always the same every month even though rent is paid every quarter. If rent is accounted for when it is paid quarterly, then the shop would appear to be performing badly in those months and well in the other months. To give a better picture of performance the rent should be charged to the period that it belongs to.

The same principle will apply to rates and insurance premiums. These costs are being accounted for on an accruals basis rather than a cash basis. Small costs may simply be accounted for when they are invoiced.

If your company uses a comprehensive accounting system such as SAP R4 or Oracle you may find costs are accounted for when you take receipt of goods and services.

Exercise

Review your own budgets – which costs are spread out over a period and which are accounted for when invoiced? Or does this happen when the goods or services are received from the supplier?

Capital costs: the difference between capital expenditure and revenue expenditure

Example 2

Rex Retail refits each of its shops every five years at a cost of £100,000. This cost is not charged directly to the P&L account as it is a capital cost, or capital expenditure.

Capital expenditure is capitalised – i.e. treated as a fixed asset and written off over its useful life (in this case five years). Each branch will see this refit cost as an annual depreciation charge of £20,000. (£100,000 divided between five years). Revenue expenditure costs are charged directly to the branches' P&L account. (Further explanation and examples of capital expenditure, depreciation and their impact on the financial statements are given later in this chapter.)

Exercise

Take a moment to review your budget.

1 Do you have any depreciation charges? (These would relate to fixed assets that are used by your business unit or department.)

2 Do you have a capital budget? (This would be a budget for spending on plant and equipment.)

Income

Revenue is recorded in the P&L account when it is earned. In the case of a retailer, the sale and receipt of cash is normally the same. Most companies give credit to their customers, so income will be earned at a different time from when cash is received from customers. In some businesses where customers pay in advance, income will still not be recognised until the goods or services have been delivered. It is important to understand the difference between income and receipts when budgeting for profit and cash flow.

Example

Question
Titan Training was commissioned to deliver an in-house training course. It received the order in January, delivered the programme in February, raised its invoice to the client in March and finally received payment in April. In which month did Titan Training earn its fee?

Answer
The fee was earned in February when the training was delivered; it is recorded as income for February.

Question
Titan Training also runs public programmes and customers normally pay in advance for these programmes. Titan ran a programme in May. The delegates paid the company in April. When should Titan recognise the income for the training course?

Answer
The income should be recognised in May when the service was delivered.

Understanding profit and loss account figures

Income

If you have income in your budgets have you ever had a problem reconciling the figures? Income in the P&L account should be recognised when it is earned. This is generally when the goods and services a company supplies are delivered. There may be some seasonality in your income; this seasonality should also be reflected in your original budget otherwise you will find variances that are purely caused by poor phasing of the original budget. When you put together your budget you need to understand when the income is likely to arise.

Expenditure or costs

You need to understand your expenditure or costs and how they are accounted for. Costs should be accounted for in the period when you gain the benefit, rather than when you pay for them.

Understanding the difference between profits (accounted for on what is called an accruals basis) and cash is fundamental when you are producing budgets.

Example

For example, the cost of a quarterly rent bill should be spread out across the months it relates to. The budget should be put together on the same basis, with 1⁄12 of the annual rent being budgeted each month, and the cost of the rent being allocated to each month on the same basis. Even though rent is being charged into each month's P&L account, it will still actually be paid each quarter and this will affect the cash flow.

Tip: understanding accrual accounting

You may come across the terms accruals, accruing or accrued. Whenever you encounter them it is more helpful to substitute the word 'matching'. Accruals accounting is just about matching costs to periods.

At the end of each period we may have to calculate accruals – costs that have arisen but may not have been invoiced by our supplier. To charge them to the period we need to 'accrue' the cost and further details are given below.

Review of accruals accounting

1 A timing difference

Profit and cash are different in the short run; in the very long run they should be the same. The timing of profit can be quite different from the timing of cash flow, as profit is accounted for on an accruals basis.

Income may be earned at a different time from when it is paid. There may be sales that have not been paid, i.e. there are outstanding debtors, or there may be goods and services that have been used but not paid for. In some companies, such as tour operators, customers pay in advance.

Costs hit the profit and loss account at a different time from when they are paid. A company may have purchased stock or inventory, the cost of which does not hit the P&L account when it is bought, but later on when benefits are gained from it. Both debtors and stock are part of the working capital (summarised below). Accounting for income and expenditure on an accrual accounting basis also requires us to account for assets and liabilities in the balance sheet (described in more detail later in this chapter), including working capital, fixed assets and funding.

2 Working capital

Working capital is made up of debtors (accounts receivable), stock (inventory) and creditors (accounts payable).

Debtors are customers to whom we have sold goods or service and who have not yet paid. Sales appear in the P&L accounts as income but do not appear in the cash flow statement. When the customer pays it will be recorded in the cash flow.

Our creditors are the organisations we owe money to and for most of us our main creditors will be our suppliers.

Stock or inventory is made up of raw materials, work in progress (part finished goods) and finished goods, or goods for resale. Stock is generally valued at the lower of cost or net realisable value (the value stock can be sold for, less the costs to sell it).

There is more detailed coverage of budgeting and managing working capital in Chapter 5.

3 Fixed assets, capital expenditure and depreciation

A depreciation charge for capital items is charged in the P&L account but does not affect the company's cash flow. Cash flow is affected by the purchase of fixed assets, such as plant, machinery and equipment, and fixed assets are also known as 'non-current assets'. Fixed assets are assets that give a long-term benefit to the organisation. They are written off (or charged against profit) over this period. There are several ways of sharing the depreciation costs to years; the most commonly used method is the 'straight line method'.

Example: accounting for depreciation and fixed assets

Assume a company purchased a van for £25,000 cash. It plans to use the van for three years then sell it for £7,000 cash. Over the three years the van will have decreased in value by £18,000. The annual depreciation would be £6,000 per year (on a 'straight line' basis). This would be £6,000 charged to the P&L account (or income statement) each year. Depreciation would not affect the cash flow. The cash