2007

NVQ Level 3 in Management

Unit E1

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Kent Learning Resources

Providing Knowledge and Understanding for Vocational Qualifications

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What is the unit about?

This unit is about having ownership of and being responsible for a budget for a defined area or activity of work. It initially involves preparing, submitting and agreeing a budget for a set operating period. It also involves monitoring actual performance against the agreed budget and taking necessary action in response to identified variances and any unforeseen developments.

Knowledge and understanding

The following is the detail of the knowledge and understanding that you need as defined in the NVQ standards. This workbook will help you with the general knowledge and understanding. Some aspects may also be covered in the workbooks for other units.

General knowledge and understanding

- The purposes of budgetary systems
- Where to get and how to evaluate the available information in order to be able to prepare a realistic budget
- The importance of spending time on and consulting with others in preparing a budget
- How to discuss, negotiate and confirm a budget with people who control the finance and the key factors that should be covered
- How to use a budget to actively monitor and control performance for a defined area or activity of work
- The main causes of variances and how to identify them
- What different types of corrective action which could be taken to address identified variances
- How unforeseen developments can affect a budget and how to deal with them
- The importance of agreeing revisions to the budget and communicating the changes
- The importance of providing regular information on performance against the budget to other people
- Types of fraudulent activities and how to identify them
- The importance of using the implementation of the budget to identify information and lessons for the preparation of future budgets

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Industry/sector specific knowledge and understanding

- Factors, processes and trends that are likely to affect the setting of budgets in your industry/sector

Context specific knowledge and understanding

- The area or activity for which the budget is for
- The vision, objectives and operational plans for your area of responsibility
- The budgeting period(s) used in your organisation
- Organisational guidelines and procedures for the preparation and approval of budgets and for monitoring and reporting of performance against budgets and revising budgets
- The agreed budget, how it can be used and how much it can be changed without approval
- The limits of your authority
- Who needs information in your organisation about performance against your budget, what information they need, when they need it and in what format
- What to do and who to contact if you suspect fraud has been committed

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Managing by Budgets

Whilst operational managers do not need to be accountants, it is necessary for them to have a broad understanding of the financial systems and controls that are in place within their organisation.

Any organisation needs to have a firm control of its financial position. The manager's role is primarily involved in:

- Controlling costs in line with budgets
- Providing management information to enable the finance department carry out their function

Cost Recording

In order to record the cost of running the organisation and the income it has available to finance the business, a set of accounts is established according to the type of cost or income. Accounts are sometimes called ledgers or simply 'books', giving rise to the term book-keeper and the procedure of book-keeping.

An account is simply a list of items of income or expenditure which record the date, amount, to whom it went or from whom it came and what it was for. Income and expenditure will usually be in separate columns. Formal accounts will be totalled and presented annually but for management control purposes within the organisation accounts are normally presented and analysed monthly.

Types of accounts

Separate accounts will be kept for each type of cost or income. These enable costs to be totalled by type. Income will be received from customers or from some other source of funding, such as grants or revenue from rates or taxes in the case of the public sector.

There will be an account for each customer so that the customer can be invoiced. Similarly there will be an account for each supplier. There will be sub accounts kept for a range of separate transaction, for example office equipment, telephones, wages.

Every income, expenditure and transfer of material will be recorded. The set of accounts will be constructed in a way appropriate to the organisation and to be useful to managers for analysis of performance.

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Activity 1

Arrange to visit your accounts department and get someone to explain the form of accounting undertaken by your own organisation.

Summarise the results of your research.

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There is an array of terms that are used in the accounting world. Whilst you do not need to have an in-depth knowledge abut them, it will be useful to have an overview.

Cost Classification

Before costs can be controlled it is necessary to understand what they are, where they come from, how they behave and who is responsible for them.

Cost Elements

There is a fundamental distinction between money invested in an organisation which is used to buy the buildings and machines and the money needed for the day-to-day activities. Money invested and used long term is called capital.

Money received by an organisation from sales is called revenue and money spent by the organisation on its activities is called its revenue costs. This can be confusing since revenue means income and cost means expenditure. The term 'revenue costs' means money spent out of revenue.

Capital Costs

Capital is money provided by shareholders, banks or Government for the purpose of buying the long-term assets of the organisation such as buildings, machines and vehicles, including office equipment and furniture. The money spent on assets is the capital cost of such assets.

Working Capital

This is the amount of capital needed for running the organisation. Some money will be tied up in stocks of material. When an organisation starts its activities money is needed to pay recurrent costs such as labour, salaries and other expenditure, before revenue from sales is received. Working capital plus the capital invested in long-term assets forms the total capital of an organisation.

Recurrent Costs

These are the day-to-day costs of operating. It is possible to identify three separate elements of recurrent cost, namely materials, labour and expenses. These in turn can be subdivided into direct and indirect costs, fixed costs and variable costs.

Material Costs

In manufacturing, a raw material or part-processed item is worked on to convert it eventually into the finished product. This material is known as

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direct material. Any such materials such as lubricants, even though they are an essential part of the process are known as indirect material as they are not an inherent part of the finished product.

Labour Costs

The machine operators who operate the machines that makes an item are classified as direct labour while the storekeeper, supervisor and inspector are indirect labour.

Expenses

An expense or service that is part of the manufacturing process, such as the cost of a sub-contracted chemical process would be a direct expense because the process is inherent in manufacturing the product.

The lorry, which takes away skips containing scrap material, is the provision of a service and is an indirect expense. There is a differentiation with things such as the cost of stationery and telephones. These are expenses under the administrative cost area not the manufacturing cost area.

Direct and Indirect Costs

Costs can be classified as direct or indirect costs. Each category will usually be sub-divided into material and labour costs and 'expenses'. Expenses are costs other than material and labour. They would include office stationary, telephone calls, electricity bills or any payment for services, in fact any money paid to someone outside the organisation except for materials.

Direct costs

Costs that can be identified with and directly related to the particular products the organisation makes and sells are known as direct costs. The labour, material and expenses used directly in the product come into this category. The sum of the direct costs is called the prime cost of manufacturing.

Indirect costs

Indirect costs are those incurred in carrying out activities but which cannot be directly related to products. Some indirect costs occur within manufacturing but most non-manufacturing costs are indirect. Such costs are described as overheads, costs that are above or add onto the direct costs of manufacturing. These overheads include indirect labour, staff salaries, vehicles (when rented), electricity, insurance, rent and local taxes. They can be separated by function such as: manufacturing, research and development, accounting, marketing or distribution. Procedures for apportioning (splitting and allocating) overheads to products are needed in order to determine the full cost of a product.

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Fixed and Variable Costs

An alternative classification of costs is into fixed and variable costs. This is useful for the analysis of how costs vary with changing volume of output.

Fixed Costs

The term fixed in this context does not mean fixed over time but rather fixed relative to changing volume of production. Fixed costs include manufacturing staff salaries, depreciation, sales and administration salaries, and other indirect costs.

Variable Costs

Variable costs are those which vary with short term changes in volume. These are mainly the direct costs. The amount of direct labour (wages), direct material and direct expenses varies proportionally with the volume of production. In order to increase volume in the short term, extra material will be used and extra hours may need to be worked or additional operators taken on.

Overhead Costs

In order to determine the full cost of a product it is necessary to include indirect costs as well as the direct costs. This requires the splitting and spreading of centrally incurred indirect costs to the manufacturing cost centres and to products. Overheads may be allocated or apportioned to a cost centre. These processes operate historically, that is they are done at the end of an accounting period. On the basis of historic expenditure it is possible to relate overhead to direct costs and to set what are known as overhead absorption rates. These are used to predict future overhead costs and are used in budgetary control.

Overhead Allocation

Where an overhead, such as machine maintenance, can be directly traced back to a cost centre the full cost of the service can be allocated to that cost centre.

Overhead Apportionment

Where an overhead such as a rent, rates or office salaries cannot be directly traced to any one cost centre, the cost must be shared between them on some fair and equitable basis. In the case of rent and rates it could be apportioned on the basis of the area occupied by a cost centre. This means that the proportion of the rent and rates bill charged to a department would be the same as the proportion of the total space that the department occupies. Heating could be apportioned by the volume or

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the number and output of heaters. Lighting by the number and wattage of light fittings etc. Insurance costs can be apportioned according to the value of assets in a cost centre.

Overhead Absorption

Once an analysis has been made of indirect cost allocation or apportionment to the various cost centres it is possible to calculate an overhead absorption rate for future use. In this way overhead costs are paid for by manufacturing cost centres as they occur.

To do this a cost per unit of output is added on top of the direct cost per unit to cover the overheads. The ratio of this additional cost per unit to the direct cost of base factor is known as the overhead absorption rate.

Costing Systems

Given the large amount of cost data, it is important that the method of organising cost data matches the organisation structure and function of the organisation. Only in this way can costs be accurately determined and sensible management decisions made.

Job Costing

Where an organisation undertakes subcontract work where each order is unique and requires different amounts of labour, material and overhead, the cost of each order must be calculated separately. Such a cost accumulation system is known as a job costing system. This system gives accurate production costs because costs are accumulated for each specific order, however, this is expensive and time consuming in terms of the clerical work involved in attaching costs to a specific job.

Process Costing

Where an organisation makes large quantities of the same product, an alternative system of cost accumulation known as process costing can be used. It is not necessary to allocate costs to a specific order; instead the cost per unit can be obtained by dividing the costs of production over the period by the number of units made in that period. This produces a cost for each process.

Product Costing

Where organisations have a range of standard products, it will want to determine costs by product and will use a product costing system.

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Activity Based Costing

Activity based costing, is a modern approach to costing which pushes costs down in more detail to cost centres and products. Overheads are allocated to a cost centre on the basis of factors relating to the overhead itself rather than apportioned to the department absorbing it on the basis of a factor related to that department.

A more detailed analysis of the electricity bill, for example, will determine the causes of its cost so that they may be allocated to a cost centre. In this way overheads are more accurately absorbed. This leads to more accurate costing of products, processes and departments and to more accurate measures of performance.

Standard Costing

Standard costing is based on the generation of standard costs. These are the expected costs based on expected volumes of output at expected efficiencies. Standard costs are costs per unit of output not the total cost of an item in a period. Standard costs are used to create budgets and to compare standard with actual costs after they have occurred.

Unit Costs

Unit costs are costs per unit of output. Output can be at component or product level. Unit costs can be calculated by dividing costs by the volume produced. It is more informative to know the unit costs and not just total costs. Total costs will change as volume changes but it is not clear how much of the cost change is simply due to volume and how much is due to changes in the price or cost per unit. Unit costs enable this analysis to be done. The price of a product is its income per unit so this is comparable with a unit cost.

Marginal Costing

To calculate the relative effect of changing manufacturing or sales volume a marginal cost can be calculated. The marginal cost of a product is defined as the change in cost that occurs when the volume of output is increased or reduced by one unit. This is measured by the total variable unit cost. Marginal costing is used to assess whether it is financially feasible to increase manufacturing volume or to calculate the effect of reducing volume, perhaps due to a decline in the market. It is based on variable costs because fixed costs are fixed. They occur and do not change if manufacturing volume changes. Marginal costs are lower than 'full' costs. The normal effect of increasing volume, subject to available capacity, is that revenue will increase more than marginal cost, the difference being the benefit of the increase.

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Cost centres

Within the organisation a set of cost centres will be established. A cost centre is a department or section for which costs are separately ascertained and recorded. Each cost centre will have its own accounts and each type of expenditure will be recorded in separate accounts. In this way, for example, not only is the total wage bill known but also how much of it is attributed to each cost centre. This enables the measurement and responsibility for costs to be delegated to different sections of the organisation.

Profit centres

The concept of delegated responsibility can be taken to the extent that, for internal purposes only, each section is an autonomous unit. This requires each cost centre to have income as well as expenditure so that its 'profit' can be calculated. It does this by 'selling' its output or services to 'customers' who are the other departments in the organisation. If this is done a cost centre becomes a profit centre. This extends the concept of the demand chain to relationships between departments within an organisation. Each department sees others as suppliers and customers.

The way in which manufacturing sections have income is to sell their products to the next section and buy their components from the previous section. This is the concept of the internal market. The price of such internal sales, known as the transfer price, is not easy to determine. Prices are normally determined by the external market and include competitive pressures. There is no such pressure internally, prices have to be negotiated or imposed from above.

Competition could be introduced if managers were free to buy their inputs from external or internal sellers, taking buying decisions at profit centre level. The profit centre concept is beginning to be used in the public sector where competitive tendering has been introduced.

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Budgeting

The proper function of budgeting is to plan, measure and control future activities. A budget is a financial plan, based on the organisation's objectives for a future period. Budgets for management use will normally be produced for each month and totalled for the financial year. Budgets are generally produced for each department or cost centre.

Term 'budget centre' is used for those parts of an organisation for which budgets are produced. A budget centre may comprise several cost centres. An organisation therefore has many budgets.

Managers will have a budget for the activities for which they are responsible. This will indicate the level of activity planned for each month for the coming year and the expected expenditure. This gives a manager a framework within which to manage the activity of their department. Budgets are plans for the future, expressed in monetary terms.

In general terms a budget can be defined as a financial expression of the short term plan for a particular part of an organisation. It is an estimate of the overall expenditure for that part of the organisation and is intended as a tool for monitoring and controlling the achievement of the relevant part of the organisation's plans.

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Activity 2

What do you understand by the term 'budget' and what is it for?