

Management Assignment One

“Controlling and managing costs and cash flow are essential financial objectives for all organisations and should lead to improved levels of profitability and liquidity. From your studies, and with the benefit of your own experience, discuss this statement and identify the policies and measures that could be implemented in order to ensure that the most effective means of cash flow management are achieved. This should also include references to, and commentary on, a working environment with which you are familiar.”

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1. Introduction

Sound financial administration is vital to the viability and sustainability of any organisation. Successful budget management will help to ensure that resources are allocated effectively and appropriately. Without efficient forward planning, monitoring and reviewing of financial resources organisations are unlikely to be able to maintain their profitability and ultimately for many organisations, especially private companies, their existence.

So how can organisations ensure that their financial administration is going to guarantee their profitability and liquidity?

For the purpose of this report I shall be examining the budget management systems of Derbyshire County Council paying particular attention to the operations within the Highway Safety Team.

Before we examine the budget management systems that the Authority has in place we need to understand and explore how costs are classified.

2. Cost Classification

All items or activities have an associated cost and managers need to be aware of the nature of these costs and how they behave both in isolation and how they interact with each other. All costs have a significant impact on the functioning of a business and we need to understand these costs accordingly.

Costs are grouped into certain classifications, which assists us in being able to understand and analyse them further. The three most common groups of classification are:

- Costs
- Functional costs
- Behavioural Costs

2.1 Costs

Costs can be broken down into three core elements

- Material costs
- Labour costs
- Expenses

Each of these elements can then be further divided into direct or in-direct costs.

- Direct Costs are those costs which are incurred as a direct result of a product or service.
- Indirect Costs are those which are not directly attributed to a product or service.

For example Derbyshire County Council's Highway Safety Team distributes a newsletter to each of its schools. The newsletter is designed by a member of the team then it is sent to a printing company to carry out the finished design and print. The newsletter is then delivered back to the Highway Safety Team to despatch to schools.

The **Direct Costs** involved in this process include

Material – paper used for newsletter, printing equipment, boxes to package newsletters.

Labour – salaries of the staff involved.

Expenses - hiring of delivery vehicle

The **Indirect Costs** involved include

Material - maintenance of print machinery, printing ink

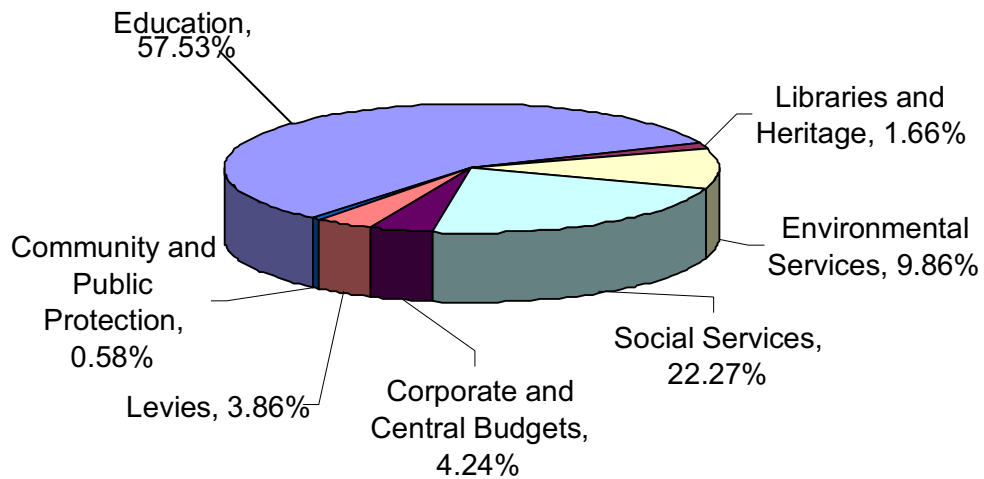
Labour - maintenance staff

Expenses - telephone charge for emailing design, building rent

2.2 Functional Costs

Most organisations have a number of departments/sections or functions within them of which each would have a cost association.

The table below shows Derbyshire County Council's 2003/4 expenditure split by departmental function. Each department will have an associated cost centre.



2.3 Behavioural Costs

Because most work is varied and not static some costs will react accordingly to changes within the work or production environment. Therefore costs can also be classified to reflect this into

- Fixed costs
- Semi-fixed costs
- Variable Costs

Fixed Costs are the only static costs and as their name suggest do not alter even when levels of work change. For example the salaries of the Highway Safety Team staff are fixed costs as these will not vary with work and are predetermined each year. Another example of fixed costs paid by the team is the rental charged for storage space. Planning for fixed costs should be relatively straightforward as they can be anticipated in advance.

Semi-fixed Costs have an element of both fixed and variable costs included. Some staff within the Highway Safety Team have an essential car user allowance. They are paid a fixed lump sum amount each month but are also allowed to claim an additional amount based on pence per mile.

Variable Costs change in direct relation to a variation in activity. Each year the Highway safety Team produces materials to distribute to schools and children who take part in Walk to School events. The amount of material produced and its subsequent cost varies directly in relation to the number of schools/children taking part the more schools take part the more costs incurred and vice-versa. It can be difficult to plan for variable costs as they can be unpredictable.

3. Cost Control

Within Local Government financial regulations provide the framework for managing and controlling an Authority's financial affairs. There are a number of Acts which govern the operation of an Authority's financial management not least the Local Government Act 1972 under which Section 151 states "Every local authority shall make arrangements for the proper administration of their financial affairs, and shall secure that one of their officers has responsibility for the administration of those affairs."

Within Derbyshire County Council the County Treasurer is the appointed Officer however many other officers at varying levels have some financial responsibility.

Cost control systems will help organisations to plan activities and in the long-term identify areas of under performance. It is therefore key that companies understand how they can control and manage costs to ensure that they remain solvent.

There are a number of systems that will help ensure that companies are able to successfully and efficiently control and manage their costs.

In order for companies to have a more detailed understanding of how different functions are performing each of these functions should be allocated a Cost Centre. This is a code to which all costs incurred or created by that function are charged.

The extract below shows a breakdown of the Highway Safety Team cost centre and some of the detailed cost codes that this is further divided into.

POLICY & PERFORMANCE ADMIN – Cost centre R5T Week 27

Detail Code	Estimate	Expenditure
R5T10 Road Safety – General	211,842	124,385.38

R5T is the cost centre allocated to the Policy and Performance Section this is then broken down further to functions within the section, in this case R5T10 allocated to road safety. This is then divided further into functions within road safety:

Detail Code	Estimate	Expenditure
R5T10 Road Safety – General	211,842	124,385.38
4630 Hardware – Purchase		45.00
4632 Hardware Maintenance		637.21
4802 Marketing, Information, Research	13,467	2,657.77

This breakdown allows the manager to closely monitor each of the functions and identify areas of over or under spend. The manager should now look at these functions further to address and understand the reasons for any significant or unanticipated variances in estimates and actual expenditure. It may be as a result of a variable cost that has not been foreseen and it may therefore be necessary to reallocate money from another function to cover this.

3.1 Break Even Analysis

Many companies exist to make profit however this is rarely the case within local authority. That said within the Highway Safety Team we have carried out a number of initiatives with the intent of at least covering any costs incurred i.e. “Breaking Even”. For example we developed an educational resource which we made available free of charge for all schools in Derbyshire. However we wanted to generate some income to cover the cost of producing the resource. Therefore we decided to expand the distribution of the resource nationally and charge for it. We calculated all the costs involved in the process of developing and producing the resources and this was the cost we charged. However this has not been completely successful as it was not possible to predict the number of copies which would be sold to external organisation and unfortunately we still have a number of sales to make before we break-even.

4. Local Government Funding

Whilst Derbyshire County Council does not aim to make a profit it does strive to deliver a best value service for its residents. Before we look at how budgets can be managed we need to look how the authority's budget is constructed.

4.1 Revenue Budget

Revenue expenditure is funding of recurring items, including the running of services and also financing capital spending that is paid for by borrowing.

Derbyshire County Council's revenue budget for 2003/4 is £652.3 million. This funding is generated from a number of sources including;

Formula Spending Share (FSS)

This is the Government's assessment for spending that is used as a method of allocating grant to local authorities.

Council Tax

When calculating the FSS the Government expects council tax payers to contribute an extra 6% towards the cost of local services. However in order to carry out a number of key service improvements the authority has set its council tax increase at 7.94%.

Business Rates

These are under the direct control of government and the same rate applies across the country. This income is collected by district and borough councils and passed to the Government who then distributes it to local authorities according to the services they provide and the number of residents living in the area.

Clearly such a large organisation with significant budgetary control needs to ensure that it has a clear planning process in place. The budget process for 2003/4 followed the following timetable

August 2002	The medium term financial plan was updated to give an indication of the likely expenditure needs and resources available over the next three years.
September 2002	Detailed assumptions for pay awards and inflation were made and the production of the base budget for 2003/4 commenced.
November 2002	Base budget produced and taken to service committees. Government issued provisional details on the amount of money the Council will get by way of grants and business rates.

January 2003	Government confirmed the level of grant and business rates available. Cabinet determined a budget and council tax levels for 2003/4.
February 2003	Council approved the budget and the council tax levels required were issued to local councils who collect the tax.
March 2003	Council tax bills were issued.
April 2003	New financial year began.
May 2003	Secretary of State for Environment makes decisions about the capping of those authority budgets and/or council taxes he deemed excessive.

4.2 Capital Budget

From 2003 the Government makes its capital allocations to local authorities via a Single Pot mechanism. It will then be for the authority to decide the amounts each service area is allocated. This will be affected by the council's priorities, policies and plans.

5. Budget Management and Control

In simple terms a budget is an expenditure plan. Within Derbyshire County Council “it is the financial expression of the Council’s plans and objectives”¹ It can help ensure that resources are allocated and effectively used for their intended purpose and that these resources are properly accounted for. The management of a budget is a continuous process undertaken throughout the financial year allowing the budget to be adjusted as necessary. Effective monitoring can help organisations to identify changes in trends and resource needs as early as possible and take any remedial action necessary.

As explained previously Derbyshire County Council operates within an annual cash limit and each service is required to manage its own expenditure to ensure that the total is not overspent. The Authority has a number of key controls in place for managing the budget these include:

- i. each “£” of budgeted expenditure is allocated to a named budget manager.
- ii. budget mangers follow an approved certification process for all expenditure
- iii. income and expenditure is properly recorded and accounted for.

An additional control for local authorities is the appointment of auditors both internal and external to ensure that the funds of the council have been properly managed.

Predicting the future is impossible. However it is possible, with efficient planning and control, to minimise the impact that certain events may have upon a budget. It should also be possible to estimate areas where future profits may be made and also areas of underperformance.

Firstly we need to consider how a budget is compiled.

5.1 Budget Compilation

It makes sense when compiling a budget to start with known costs which are easily determined. These could include items such as

- Rent
- Salaries
- Business Rates

¹ Derbyshire County Council Financial Regulations 2002

When compiling the Highway Safety Team budget known overheads include rent, clothing allowance and annual maintenance fees for internal equipment.

Once known overheads are identified it is then necessary to consider estimated overheads. These are items where the cost will vary in direct proportion to the volume of work/activity. For example within the Highway Safety Team there are a number of activities where costs may vary including telephone calls, printing of materials and postage.

Finally we need to look at the areas where we are able to control the amount of money allocated and this will usually be apportioned from the remaining money available. Within the Highway Safety Team this includes non-recruitment advertising, purchasing of resources and marketing.

There are a number of ways in which we can determine the appropriate amount of money to be allocated to an item or activity. Incremental budgeting is one method whereby budgets are set taking into account information and data from the previous year or few years budget. This is the main method of budget allocation within the Highway Safety Team. Some adjustments are made, as necessary, especially if there has been a significant overspend or under spend within a particular service area. The main benefit of this method is that costs are being allocated based on generally sound knowledge and experience and it should not lead to any significant variances at the end of the financial year. However is not without its disadvantages and may lead to problems being exacerbated, especially if there have been errors with budget allocations in previous years that have not been identified and / or rectified.

An alternative or additional method for budget compilation is zero-based budgeting. This is where costs are allocated as new each year without any reference to previous years budget information. Whilst this method of budget compilation is less well used within the Highway Safety Team it is used in some instances. For example in 2002 the team was awarded significant additional funds under the Council's Public Service Agreement. Conditions on this funding meant that it could only be used on brand new initiatives never carried out before. Therefore the costs for these initiatives were allocated from scratch using almost a best guess method. Problems with this method will arise if some sound knowledge of the product or service is not taken into account prior to setting the budget.

6. Cash Flow

Cash flow is basically the receipts / cash coming into a business and the payment / outgoings being made by the business. Problems can arise in businesses when cash flow is not managed correctly especially when companies allow credit payments to be made for goods and do not have access to cash to meet its own overheads. If a company does not maintain a healthy cash flow then it will experience difficulty in meeting payments for its overheads such as lighting, salaries and maintenance. Wherever possible a company needs to ensure that its incoming payments are at least equal to its outgoing payments. When this is not the case a company may have to borrow money to enable it to meet its overheads and eventually a company may even be faced with liquidation. Liquidation takes place when a creditor of the company takes action under the Insolvency Act 1986 to wind up a company to retrieve its outstanding credit. The assets of the company are collected and then any outstanding debts are paid off using the income generated by the sale of these assets. Just because a company is profitable, however, it does not automatically follow that it will remain liquid. Many successful companies fall into liquidation because they are not managing their cash flow effectively and whilst their sales may remain high or increase they cannot recoup their costs quick enough to cover the increased overheads generated by the increase in sales demand.

Many hundreds of millions of pounds pass through Derbyshire County Council's books each year. And whilst councils would not go into liquidation a few councils have suffered high profile losses through inappropriate budget management procedures. Whilst I have no working knowledge of a company going into liquidation the following is a news extract regarding the recent high profile case of The Accident Group.

“ ‘Accident creditors seek liquidation’

Creditors of The Accident Group have voted to put the company into liquidation.

The Manchester-based firm collapsed in May owing more the £100 million and leaving more than 2,500 staff without jobs. Creditors...met the administrators PriceWaterhouseCoopers....voted unanimously to put the firm into liquidation...administrators blame TAG's lower than expected claims success rate for the financial difficulties, which they say resulted in increased premiums on new business and retrospective claims from the underwriters. “²

² BBC News Friday 26th September 2003

So how can organisations prevent this type of situation? It is accepted that income may not be recouped immediately therefore cash flow needs to be managed closely. A cash flow forecast/budget needs to be developed to act as a control. Basically this should be a forecast of the amount of incoming and outgoing funds over a set period. This will help to identify at least what income needs to be generated to ensure that outgoings are being met and help plan when certain payments, such as fixed costs, can be made. This will also help to identify what cash a company may have left at the end of that period. This may be a surplus or a deficit in which case contingency plans can be put in place to address this in advance. However cash flow forecast is not without its difficulties. The business environment is extremely dynamic and there are many external factors over which organisations have no control. These are often difficult to predict therefore companies need to allow for some uncertainty in forecasting, underestimating the likely income and overestimating anticipated expenses can help.

7. Benefits of Budget Management

There are a number of non-profit benefits for companies to adopt a budget management process;

Planning and Coordination

Budgets will help with long term planning and clarification of policies and objectives and will enable the coordination of activities to support the master budget. It provides a focus for managers to look at the contribution of their function to service provision and organisational objectives.

Authority and Responsibility

Budgeting makes it vital to identify and clarify lines of management accountability. It encourages understanding and responsibility within managers.

Communication

Communication is vital throughout a budget system. As many functions/services are reliant on each other it is necessary for each to know how the other is performing.

Motivation

Involving as many tiers of management in budget setting as possible and setting reasonable performance targets linked to this can help motivate staff.

Performance Management

It helps to measure performance and can identify areas of strength and weakness and allow appropriate proactive action to take place.

Efficiency

Ultimately efficiency should be improved and resources allocated appropriately and cost effectively.

8. Conclusion

Without effective financial management the profitability and ultimately the liquidity of an organisation is seriously affected. Companies need a clear understanding of the costs involved in providing their product/service. Once these are understood then efficient budget controls and monitoring need to be put in place to ensure the effective running of the organisation and its funds.

Ultimately a rigorous budget control and management system will provide managers with a greater understanding of the cash workings of the organisation. This will allow proficient forward planning and with regular monitoring should help prevent a situation whereby an organisation is unaware in advance of any financial difficulties, thus allowing organisations to put contingency plans into place before it gets to the point of liquidation.

Organisations need to, as far as is reasonably possible, accurately forecast cash flow. If this cash flow forecast is unreliable then there will be less money available for resources leaving companies unable to pay and facing liquidation.

Effective cost control will also help the overall efficiency of an organisation, not just in profit terms, and will identify areas of strength and weakness within the service thus enabling better forward planning. Finally quality cost control will help ensure that the organisation is meeting its desired objectives.