BUDGETING FOR EFFECTIVE COST CONTROL

Budget Development and the Use of the Budget for Cost Control

The time invested to prepare a detailed, well-constructed budget will pay dividends when the budget is used as a primary tool in the development and implementation of an effective cost control process. While many types of budgets might be developed for your program, it is the operating budget which serves as an important tool for cost management. The operating budget details your income sources and the amount of income anticipated for the operating period as well as details regarding your anticipated expenses for all expense categories for the operating period.

Preparation of an operating budget

Generally, an operating budget is prepared for the full operating year, as well as for the monthly periods comprising that operating year. To prepare the full operating year's budget, monthly budgets are first calculated. Then, when the monthly budgets are completed, the figures for the 12 months are totaled to form the budget for the complete operating year.

There are several steps involved in the development of an operating budget that will function effective as a cost control tool. These steps are the following:

1. Identify and collect relevant historical information about the program, its funding sources, and expenses. Evaluate this information relative to the anticipated future operating year. Consider if funding sources will continue to be viable; possible changes in revenue provided by the various funding sources; and possible changes in the various cost categories. Changes which might impact your budget could be either external to your program (the current economic conditions) or internal program changes that you are planning or both.

2. Calculate the revenue anticipated for the operating year. If the revenue flow is expected to be constant throughout the year, then the revenue for one month could be calculated - then that value would be multiplied by 12 to calculate the anticipated annual revenue. However, if there are usually month to month fluctuations in program revenues as a result of various fund raising activities, changes in program participation numbers, etc., then your budgeting accuracy will be improved by calculating your anticipated revenue for each month separately - then summing the revenue for the 12 months to calculate the total revenue anticipated for the operating year.

   It is important to calculate anticipated revenue prior to considering the program's expenses as the program must be planned so that expenses do not exceed available revenue.

3. Calculate the monthly fixed expenses. Fixed expenses are expenses which are not likely to change during the operating year. They may be expenses over which you have limited control. Examples of such expenses would be rent paid for the program facilities, fees for contracted services, or expenses for utilities such as your telephone service, Utility cost estimates should be based on past years' costs with any adjustments made for changes in rates for any of your utilities.

4. Calculate the cost of foods and beverages served to your clients. You can use previous years' costs per meal for this calculation if this cost is acceptable to you. Or if you are wanting to improve your cost management and have standardized pre-costed recipes for use in your program, you can calculate an average cost for a planned meal that you would serve your clients and use that figure for these calculations. The monthly meal costs would then be calculated by multiplying the average meal cost by the number of clients you anticipate serving that month (number of clients anticipated per day times the number of days you are providing meal service during the month).

5. Calculate the cost of supplies for the month. Packaging materials are a major supply cost. Since you have previously calculated the number of meals you anticipate serving for the month, you can multiply that number by the cost of packaging materials required per meal to obtain the monthly cost of packaging supplies. Then based on previous year's usage and costs incurred, you can calculate an estimated monthly cost for additional supplies such as cleaning chemicals, paper, paper towels, etc. and add that cost to the cost of the packaging supplies to calculate a total supplies cost for the month.

6. Calculate labor costs for each month. Your labor is likely to be a mix of paid and volunteer labor. The costs of all administrative personnel (based on their employment contract adjusted for any changes in salary levels anticipated during the year) along with the costs of any benefits provided for salaried personnel must be included in the estimated labor costs. If any benefits, such as meals or reimbursement for vehicle mileage, are provided to the program volunteers, the cost of these benefits in included in your labor cost calculations. Finally the hourly labor costs are calculated by multiplying the number of hours that it is anticipated that each category of employees will work during the month by their hourly rate. The costs of any benefits provided to your hourly employees (vacation time, sick days, insurance, etc.) are then added to the anticipated hourly wage costs.

7. Sum the calculated anticipated costs. The total anticipated costs cannot exceed the anticipated revenue. If your calculated costs initially exceed your revenue, then you will need to review and recalculate expenses until you have prepared a balanced budget.

Calculating actual operating costs incurred

Usually actual costs are calculated monthly, a time period corresponding to the monthly operating budget. Since most fixed costs are established by contracts and other costs, such as utilities, can be readily identified from billings received from the utility companies, it is the actual food/beverage costs and the actual labor costs for the period that are more difficult to calculate. Actual labor costs for paid personnel (both salaried and hourly personnel) can be derived from payroll records. When calculating labor costs, it must be remembered that it is gross pay plus the cost of any benefits which the program paid for the personnel that must be calculated as the actual labor costs. In addition, the cost of any items provided to volunteer personnel must be estimated and added to the labor costs identified from payroll records. For example, if meals are provided to volunteers, the estimated food cost of the meal can be multiplied by the number of volunteers for whom meals were provided to estimate that portion of your actual labor costs.

The calculation of actual food/beverage costs require you to have calculated the value of the physical inventory that was taken at the end of the period. Actual food costs are calculated by adding the purchases made during the month to the opening value of the inventory (which is the value of the previous month's closing inventory); then deducting the value of the current month's closing inventory. The balance is the actual cost of the food/beverages consumed and would also be your actual food cost unless meals were provided to volunteers or paid employees and the cost of those meals is allocated to your actual labor costs (a correct allocation for employee/volunteer meal costs). If meals are provided for personnel, then the cost of those meals must be deducted from the cost of food consumed. The balance, then is the actual cost of food/beverages for the month.

Using the operating budget for cost control

When your operating budget is carefully prepared, it becomes your standard for both your revenue receipts and your costs, relative to an anticipated revenue level. As the standard for your operating costs, you will be able to facilitate the management of your costs by comparing the actual costs incurred by your program with the standard budgeted costs. There will likely be some variance between the actual costs incurred and your standard costs. You will need to make a determination if this variance is significant, i.e. if the variance warrants the investment of management time and effort to investigate the cause of the variance. (See discussion of the control process, p. 1 of this handout)

If you determine that the variance is not significant, then there is no further action that is needed. If you consider the variance to be significant, then as indicated previously in the control process, possible causes for the variance must be investigated. Significant variance could be either positive (actual costs exceeded budgeted standard costs) or negative (actual costs were less than budgeted standard costs). Even though having actual costs that are less than the budgeted costs may seem to be a positive situation for you, it may not necessarily be so as inferior quality products may have been used or standard recipes may not have been followed or standard portion may not have been served. Thus variances indicating that actual costs were less than the standard, budgeted costs must be investigated just as diligently as if the actual costs exceeded the budgeted costs. If a problem is found which can be corrected, then action must be taken to implement changes to correct the problem. If the cause of the variance is not controllable by your program (i.e., changes in utility rates lead to increased utility costs), then you will need to either find a way to increase your revenue enough to offset the cost increase, or you will need to find a way to decrease expenses in one or more of the other expense categories.

When preparing an operating budget, revenue should always be calculated before estimating expenses as program expenses cannot exceed expected revenue.

A carefully prepared operating budget functions as an effective tool for managing costs when actual costs incurred are also carefully calculated and compared to budgeted costs to determine the variance of the actual costs from the budgeted costs. When significant variances are identified, you have the opportunity to make changes to correct the variances to bring actual costs in line with your planned costs relative to your anticipated revenue.

PROGRAM SELF-EVALUATION:

1. Have you prepared a monthly operating budget in sufficient detail that it can be used as a tool in our cost control process? If not, why not?

2. If not, do you feel that you have the historical information and other necessary information to prepare a detailed operating budget?

3. Do you have a system in place to collect accurate actual cost data (computerized inventory system, means of tracking any items provided for volunteers, accounting records for payroll costs, etc.)?

4. Are you currently comparing your actual costs to your budgeted costs to determine the cost variances? If not, why not?

5. Do you have criteria for determining if variances are significant? If so, do you apply those criteria to your budget cost variance analysis and only investigate significant variances?

6. If significant variances are found, are you following the control process to determine the cause of the variance and eliminate it, if possible? If not, why not?