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Budgeting and Controlling – Part 3

The Structure of a Profit Plan

The first two articles of the series Budgeting and Controlling have covered the contents of the new legal obligations for budget compilation (BTV-Aktuell 3/1999) as well as the individual components of the complete budget of an enterprise (BTV-Aktuell 4/1999). In this article and the following ones the detailed structure of profit plan, finance plan and budgeted balance sheet are dealt with. This article begins with the description of the profit plan and how to deal with issues that require special consideration.

The first stage in a company's budget is calculating a profit plan. Projected sales, variable costs and fixed costs are contrasted against one another in the profit plan.

In its simplest form, a profit plan has the following structure:

	Sales
–	Variable costs
=	Contribution margin
–	Fixed costs
=	**Operating result**

The differentiation in fixed and variable costs is important for the structure of a budget, above all for the considerations that can be derived from the budget for the enterprise. It is, therefore, necessary to differentiate principally between long-term and short-term consideration.

In the long run, all expense items are controllable. In the framework of budget compilation, the budgeted period normally refers to one year or one business year. In this short-term period a separation into fixed and variable costs according to simple decision-oriented considerations has proved most valuable.

When taking these consideration into account, variable or proportional costs are those costs that vary automatically according to changes in sales or income. This means, that variable cost are rising when sales are increasing and fall when sales are going down.

All other costs that do not adapt to changing sales situations automatically, are called fixed costs. Of course, they can be modified but they do not change automatically. This means, that when fixed costs are changed a concrete decision must be made for modification and to indicate the extent.
Fixed costs: change follows a decision
Variable costs: change happens automatically.

Consequent separation into fixed and variable costs is crucial for the considerations that can be derived from the budget of an enterprise to interpret plan-modifications and statements of ratios.

Only when all cost items according to the described criteria are incorporated into the budget (Fixed costs: change follows a decision, Variable costs: change happens automatically when sales change) statements of ratios like minimum turnover, volume range and price range can be interpreted correctly. With these ratios the scope for action of an enterprise can be presented.

In the next article of the series Budgeting and Controlling the above mentioned ratios minimum turnover, volume range and price range will be reflected more closely.

About the author:
Prof. Werner Seebacher (PhD), Management Consultant, special field: corporate planning and controlling, lecturer at several universities.
Contact:
Seebacher Unternehmensberatung GmbH, Munich, Graz.
office@seebacher.com
www.seebacher.com

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