Step by Step to Understanding & Implementing Key Concepts for Departmentalized Profit & Loss Statements

If you have a departmental profit and loss statement already, you probably understand its importance to operating effectively, and improving the decision-making process. One of the keys to maintaining the decision-making process is to decide on a few issues:

1. When do I add an additional department to my profit and Loss Statement?
2. If I want to departmentalize my overhead, how do I go about doing this?

When to add an additional department?

Consider these factors when adding a new department to your profit and loss tracking:

1. How much work are you doing in the market segment?
2. How much work do you plan to do? In other words are you entering a new strategy or a new market and dedicating resources to make sales occur?
3. Do you have the need to determine the pricing that will come from the important profit and loss statement?

If you are departmental down to the gross margin level in your profit and loss statement, so long as you know the proper or desired gross margin requirements for the market segment, you can effectively price your products and services.

And while there are no hard and fast rules for adding more departments and structure, here is the basic guideline we recommend:

1. If you are entering into a new market – go ahead and do it so you can determine how effective your performance was based on your investment.
2. If you are selling more than 5% of your products and services in any segment of the market, it is probably worth adding the department to the list – if you are growing the segment. Since the growth is occurring, it can obscure your profit margins due to the increasing mix changes occurring.
3. If you want to set up departmental key performance measures – it is always a good idea to know what the performance is if someone is being held accountable for departmental performance.

Obviously if you are adding departments, you will recognize the need to adapt your chart of accounts and your accounting ledgers and codes, adapt your time tickets, invoices, forms and all other impacted areas.

Allocating departmental overhead is a little more complicated.

This is frequently asked and often misunderstood subject.

When should I allocate my overhead? Isn't it a better way to have accountability?

The departmental allocation of overhead can be complex, but there are some basic guidelines to consider before you actually do it:

1. Ask yourself why you are doing it?
2. Understand there are more administrative tasks associated with allocating and departmentalizing overhead – are they worth it?
3. It usually doesn't make sense to begin thinking about allocating overhead until the company is large enough to benefit by the process of doing so. This size is highly personal, yet experience as a guideline suggests somewhere around 6 million in revenues leaves the company enough employee separation of duty and focus in areas of the business to begin to make sense. 10 million is a much better point, but this is a highly personal choice, and we have seen companies successful at 6 million, and some that have made it a travesty at 6 million due to employee infighting about crossover roles and who deserved the overhead costs!
4. It is also a must that the company has the accounting competency to make the transition from departmental statements at the gross margin level, to departmental overhead.
5. Depending upon the reasons you are making this consideration a reality, be prepared for some employee gnashing of the teeth, due to the growing and learning pains that will come with this process.

Understand the steps to allocation of overhead.

1. Whatever method you use, you must commit to remaining consistent or you will lose the year over year comparisons you will want to have.
2. No one standard method is full proof from making some parts of the overhead costs allocate to a department, without looking out of line with what the department actually used in terms of overhead. The methods are:
   a. Percentage of Sales
   b. Percentage of Labor Hours
   c. Management Discretion
   d. Combination of any of the three above

Let us discuss these practices.

The percentage of sales method is the easiest method. Accounting simply calculates the sales mix of each department and breaks out any overhead expense in this ratio.

The problems are obvious. Does the commercial installation department deserve to bear the burden of yellow page advertising, or a marketing home show expense? Also, commercial sells a one-time large job because the bid was low (is this effective marketing?) and whammy, a large chunk of overhead is flying your way. **It would be a difficult case even for Johnny Cochran!**

The percentage of labor hours method is next, and like sales, we simply calculate the ratio of labor hours each department used as a percentage of our totals, and use the assumption that labor drives overhead (it does by the way), and that this assumption allows us to break out all costs of overhead by the labor hours used.

Same problem as percentage of sales, although is a more accurate, it still assigns burden across all overhead accounts, **not allowing for the idea that markets segments of the company have different expenses that apply to developing sales.**

Next method is management discretion where the head of state, the chairman, the pope, and the governor, whoever decides on the basis of what he/she believes, is fair. So commercial does not get the overhead for yellow page ads, but does get the golf membership at the club? This method is fine, and it has the advantage of discussion, because there will be lots of it. Bottom line is as a leader; you probably don't want to put yourself in the position of deciding what is fair or not on every single chart of account.

Last method, the combination of sales, labor hours and management discretion. Best method. Get you teams together, and have them review the chart of accounts, one by one, and come up with a conclusion about what overhead account needs what method. Some are best based on sales, some on labor; some need a management decision (like where you put the owners salary and how it is spread?). Here is your model to use:

Discuss → **Conclude** → **Commit** → **Create** → **Execute** → **Measure** → **Feedback**

Once you have decided what account, in what department applies, you can apply the overhead costs to the accounts in the varying departments. Stay as consistent as possible over time.

The weakness of this method is some may feel it can be complicated, and at first it may be. The discussion phase can be intense. If people in your organization are being paid on performance, this can be a sensitive subject.

Remember to change the new performance based pay plans to fit the new allocated overhead structure.

Allocation of Departmental Overhead is a good step if you are ready for it!

Why is this critical to your success?

- Adding departments to the tracking of your profit and loss statement can be effective in compensation plans, and learning about your business growth, and business mix.
- Departmentalizing your overhead can be tricky, but when it is done well, it makes the company more effective and more accountable for the performance in the market.
- A well-organized allocated overhead structure leads to a pricing effectiveness that cannot be attained with only gross margin level departmentalization. Truly knowing the overhead in any given market segment allows total flexibility in pricing methodology, and greatly improved accuracy!
- **Having a detailed accounting structure, with a fully departmental profit and loss statement is an extremely effective way to MAKE MORE PROFITS!**