

PLANNING, CONTROL & THE BUDGETING PROCESS

READING: CHAPTER 13 – DRURY- COSTING: AN INTRODUCTION

INTRODUCTION

- ◆ Key objective of management accounting
 - to ensure proper planning & control
- ◆ Important tool in achieving this
 - Budgetary Control
- ◆ Relationship with long-term strategic planning
 - ❖ *Strategic Planning*
 - non- routine
 - outcome usually expressed as an agreed course of action
 - not a quantified plan
 - relate to different time periods
 - very often periods not defined
 - ❖ *Budget*
 - Deals with specified time periods
 - Sets out detailed quantified projection
 - Of all activities
 - Normally prepared after the strategic plan is finalised
 - However, usually necessary to prepare budgets for a range of proposed courses of action, to select the most desirable one.
 - Interaction between the processes
 - Budgetary control plays an important role in the planning process

DEFINITION

“A Budget is

- A plan quantified in monetary terms,
- prepared & approved prior to a defined period of time
- usually showing planned income to be generated
- and planned expenditure to be incurred
- and the capital to be employed
- in the relevant period
- to obtain a given objective

REASONS FOR PRODUCING BUDGETS

1. PLANNING

- Detailed planning is essential for budget preparation
- Therefore, planning of all activities & segments is ensured

2. COORDINATION

- All departments / segments of a business come together and are reconciled in a common plan

3. COMMUNICATION

- The final agreed budget provides an unequivocal record of expected performance by all units of the business
- Misunderstandings minimised

4. MOTIVATION

- if properly used, can provide powerful incentives
- to employees and management, at all levels
- provides a standard against which performance is measured

5. CONTROL

- assists management to control the activities for which they are responsible
- provides regular feedback
- actual results are compared with budget
- corrective action taken, or
- capitalise further on favourable developments

6. PERFORMANCE EVALUATION

- provides a yard stick against which actual performance is compared
- necessary for motivation
- necessary for control

BUDGETS - V - FORECASTS

- Fundamentally different

Budget

- a management plan
- implications that positive steps will be taken
- to make actual results correspond with plan

Forecast

- merely a prediction
- no implication that it will shape future events
- May / may not be realised

General Characteristics are as follows:

Budget

1. Stated in monetary terms
2. Definite period e.g. 1 year
3. Acceptance & commitment
4. Approved by higher authority
5. Fixed, once approved
6. Variances analysed

i.e. includes both planning & control aspects

Forecast

1. Need not be in monetary terms
2. Can be for any period
3. No commitment to achieve
4. Not usually approved
5. Updated with new information
6. No regular formal analysis

i.e. only includes planning aspects

PRINCIPLES OF BUDGETING

To obtain max. benefit from budgets

1. Top management support
 - crucial to success of the budgetary process
 - attitudes of top management contagious
2. Not fixing blame
 - must not be seen as fixing blame or pressurising workforce
 - Should engage in participative budgeting
3. Responsibility
 - not held responsible for cost & revenues over which no control
4. Communicated clearly & in good time
4. Flexible
 - Should allow for some flexibility
6. Results communicated

BUDGET ADMINISTRATION

1. Budget Committee:

- consists of top management
- Managing Director, Finance Director, department heads
- Main function
 - to approve department budgets
 - review & authorise changes
- Responsibility to ensure that all budgets are consistent with each other and with overall Co. policy
- Reviews actual performance on a periodic basis

2. Budget Officer

- Responsible for the day to day administration of the budget function
- Reports to the committee
- Provides advice & educates users of the budget

3. Budget manual

- Collection of accounting instructions
- Governing:
 - responsibilities of persons
 - procedures & records re: preparation & use of budgets
- provides samples of budgetary documentation
- Gives general guidelines on the timetable

4. Budget Period

- the period for which the budget is prepared & used
- may be sub-divided into control periods
- usually one year, split into months for control purposes

Stages in the budgeting process

1. Communicating details of budget policy

- To those responsible for preparing the budgets
- Long term plan is the starting point
- policy effects on the LT plan must be communicated e.g. changes in the expected production / product mix etc

2. Determining factors that restrict performance

- e.g. sales demand/production capacity
- Preparers must determine these factors prior to budget preparation

3. Preparation of the Sales Budget

- Volume
- Sales Mix
- Customers / contracts
- Drives the budget
- Most important plan in the budget

4. Initial preparation of the various budgets

- preparation of the budget should be from the “bottom up”
- i.e. should originate at the lowest level of management
- Refined & coordinated at the higher levels
- Managers participate in the preparation of their own budgets
- Increase the probability that they will accept the final budget

5. Negotiation of budgets with superiors

- Negotiations between each level in the budgetary process
- i.e. the manager who initially prepares the budget negotiates with his superior and this continues up the ladder
- until final budget is agreed

6. Coordination & review of budget

- all budgets must be examined in relation to each other
- Some may be out of balance with others
e.g. Purchasing budget will partially depend on sales budget
- considered in light of
 - objective of the entity
 - constraints (finance available)
- Any inconsistencies are brought to light to the manager involved
- Budgeted P/L, BS and cashflows usually prepared to ensure the acceptance of the budget as a whole.
- Reviewed consistently and adjusted numerous of times before final budget is arrived

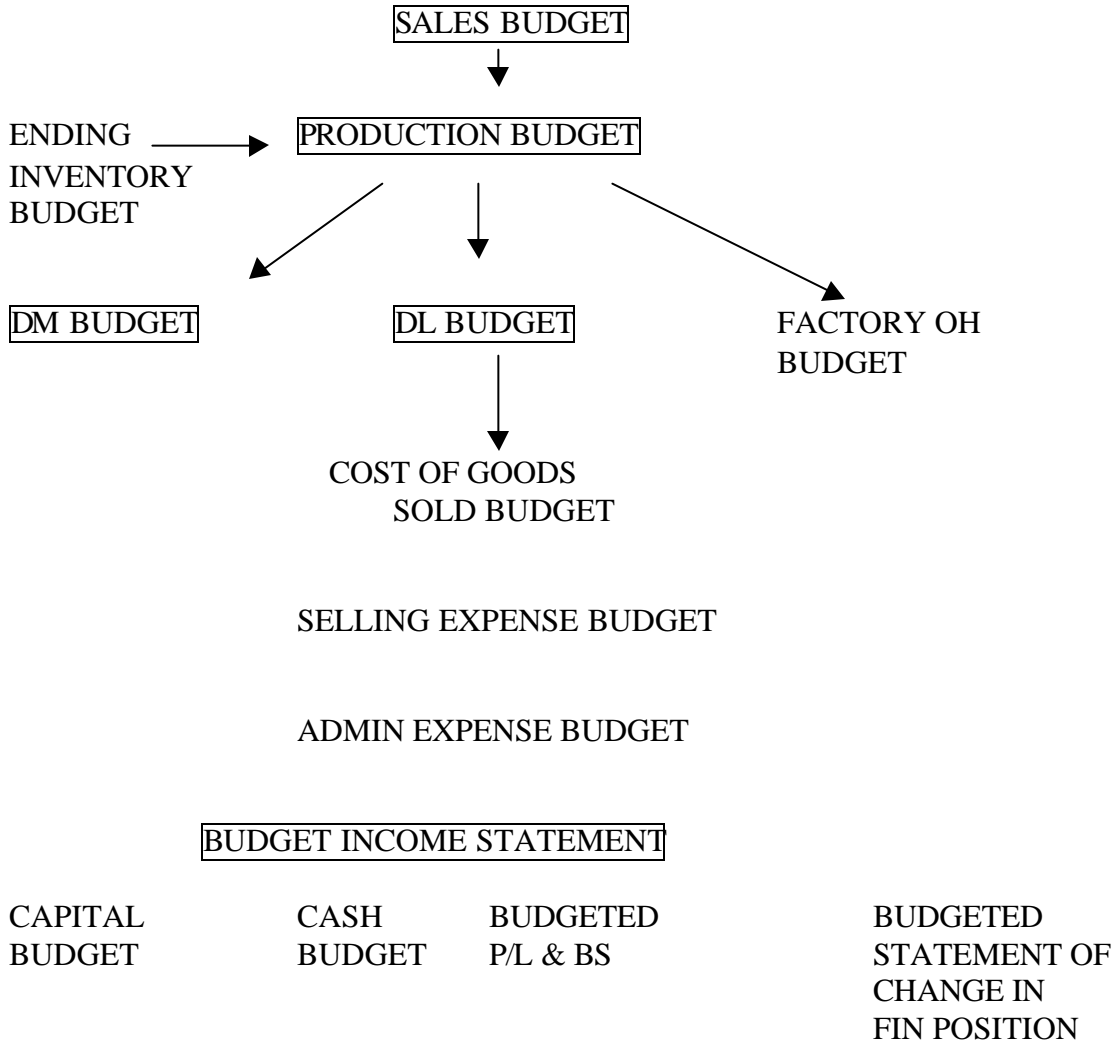
7. Final Acceptance

- When all budgets are in harmony with each other
- summarised into a “Master Budget”
- consists of a P/L, BS & Cash flow
- Approval of master budget = authority to managers responsible for each department/ segment to implement the agreed plans

8. Ongoing review of budgets

- continuous review of actual compared with budget
- highlights problem areas
- managers must report on what action they are going to take to get back on track
- Can be revised for unforeseen economic conditions etc.

MASTER BUDGET – SUMMARY OF ALL FUNCTIONAL BUDGETS



CASH Budget

- * Predicts the effect of budgeted operations- selling buying, paying wages, investing in assets on the cash balance of the company
- * Usually prepared at least per month.
- * Cash Budget aids in avoiding unnecessary idle cash and unnecessary cash deficiencies

Main Sections:

1. Cash Receipts:

- Opening cash, plus
- Cash receipts (inflows) from customers
- Cash receipts from other sources (rental Income, Interest received, etc.)
- Receipts from financing
- Must establish prospective collectability of accounts receivable
- Key Factors:
 - (a) Average time lag between sales and when cash is actually received
 - (b) Bad Debt experience

2. Cash Payments:

- (i) Material purchases – depends credit terms given by suppliers & payment habit of M Company
- (ii) D. Labour – depends on payroll dates
- (iii) Other payments – e,g interest on loans - depends on payment dates
- (iv) Capital outlay – Planned for

NB: Depreciation

- Does not constitute a cash transaction
- It does not affect cash flow
- Never include on a cash flow statement

- ❖ Excess cash
 - Loans may be repaid
 - Short term investments made
- ❖ Shortfall
 - May require additional financing on the form of bank o/d

- ❖ Permanent interest outlays – included in this section

3. Ending cash balance

Op Balance + receipts – payments +/- financing

Cash Budgets- Questions

Question 1

R. Jeeves asks your advice. He has exactly £1,000 cash with which to start a business. He has also received permission from a bank manager to have an overdraft of up to £10,000 during his first six months of business starting Jan 1st 2000.

His plans for his first six months of trading are:

Payments for goods and supplies:

	£					
January	Feb	March	Apr	May	June	
5,500	7,200	9,700	10,500	9,600	6,900	

Receipts from debtors will be: £.

Jan	Feb	March	April	May	June
3,900	5,900	6,000	7,100	8,400	9,500

Loan receivable on 1st March £700 to be repaid in full plus £100 interest on 1 June
Drawings of £300 per calendar month.

You are required to draw up a cash budget for each of the six months to 30 June 2000.

Question 2

John Smith started a business in November 1998 after being made redundant from his previous job. He received a substantial cash payment on leaving his job, however having purchased machinery and premises he had a bank overdraft of £30,000 on 1st Jan 1999.

Prepare a cash budget for Smith's business for the first four months of 1999 from the following forecasts.

1. Sales were budgeted as follows £

Nov	Dec	Jan	Feb	Mar	April
20,000	80,000	80,000	80,000	90,000	100,000

It is believed that debtors will settle according to the following pattern.

50% in the month of sale
25% the following month
25% after two months

2. Purchases were expected to be. £

Dec	Jan	Feb	Mar	April
90,000	90,000	80,000	70,000	70,000

One month's credit is received from suppliers.

3. Wages are expected to be £

Dec	Jan	Feb	Mar	April
10,000	11,000	10,000	12,000	9,000

Half of these are paid in the month that they are incurred and the rest a month later.

4. Overheads are budgeted as £

Dec	Jan	Feb	Mar	April
8,000	10,000	9,000	4,000	11,000

These are paid as they are incurred and include £1,000 depreciation per month

5. Smith intends to take £2,000 per month in drawings

6. A loan of £50,000 is to be received in February and is repayable in full in July. Interest of £1,000 per month is to be paid on this loan.

7. Taxation of £20,000 is to be paid in March.

8. Equipment is to be bought in January for £50,000 and paid for in April.

Question 3

From the following information which relates to George and Zola, you are required to prepare a month by month cash budget for the *second half* of 1995.

- (a) The company's only product, a calfskin vest, sells at £40 and has a variable cost of £26 made up as follows. Material £20 Labour £4 Overhead £2
- (b) Fixed Costs of £6,000 per month are paid on the 28th of each month.
- (c) Quantities sold/to be sold on credit

May	June	July	Aug	Sept	Oct	Nov	Dec
1,000	1,200	1,400	1,600	1,800	2,000	2,200	2,600
- (d) Production quantities

May	June	July	Aug	Sept	Oct	Nov	Dec
1,200	1,400	1,600	2,000	2,400	2,600	2,400	2,200
- (e) Cash sales at a discount of 5% are expected to average 100 unit a month.
- (f) Customers are expected to settle their accounts by the end of the second month following sale.
- (g) Suppliers of material are paid two months after the material is used in production.
- (h) Wages are paid in the same month as they are incurred.
- (i) 70% of the variable overhead is paid in the month of production, the remainder in the following month.
- (j) Corporation tax of £18,000 is to be paid in October.
- (k) A new delivery vehicle was bought in June, the cost of which, £8,000 is to be paid in August. The old vehicle was sold for £600, the buyer undertaking to pay in July.
- (l) The company is expected to be £3,000 overdrawn at the bank at 30th June 1995.
- (m) The opening and closing stock of raw materials, work in progress and finished goods budgeted to be the same.

Question 4

A company's estimated pattern of costs and revenues for the first four months of 1997 is as follows.

(£'000)

Month	Sales	Materials	Wages	Overheads
Jan	410.4	81.6	16.2	273.6
Feb	423.6	84.8	16.8	282.4
Mar	460.8	93.6	18.3	306.7
Apr	456.3	91.2	18.6	304.5

- (a) One quarter of the materials are paid for in the month of production and the remainder two months later: Deliveries received in Nov 1996 were £78,400, and in December 1996 £74,800
- (b) Customers are expected to pay one-third of their debts a month after the sale and the remainder after two months: Sales are expected to be Nov 1996 £398,400 and in Dec 1996 £402,600.
- (c) Old factory equipment is to be sold in Feb 97 for £9,600. Receipt of the money is expected in April 97. New equipment will be installed at a cost of £38,000. One-half of the amount is payable in March 97, the remainder in Aug 97.
- (d) Two-thirds of the wages is payable in the month they fall due and one-third one month later: Wages for Dec 1996 are estimated at £15,900.
- (e) £50,000 of total monthly overheads are payable in the month they occur and the remainder one month later; total overheads for Dec 96 are expected to be £265,200.
- (f) The opening bank balance for 1st Jan 97 is expected to be an overdraft of £10,600.

Prepare the cash budget for the period Jan-April 1997.

Question 5

Peter Blair has worked for some years as a sales rep, but has recently been made redundant. He intends to start a business on his own, using £15,000 which he currently has invested with a building society. Peter maintains a bank account with a small credit balance, and he plans to approach his bank for the necessary additional finance. Peter asks you for advice and provides you with the following additional information.

- (a) Arrangements have been made to purchase fixed assets costing £8,000. These will be paid for at the end of Sept and are expected to have a five-year life, at the end of which they will possess a nil residual value.
- (b) Stocks costing £5,000 will be acquired on 28th Sept and subsequent monthly purchases will be at a level sufficient to replace forecast sales for the month.
- (c) Forecast monthly sales are £3,000 for October, £6,000 for November and December and £10,500 from January 2000 onwards.
- (d) Selling price is fixed at the cost of stock + 50%.
- (e) Two months credit will be allowed to customers but only one month's credit will be received from the suppliers of stock.
- (f) Running expenses, including rent but excluding depreciation of fixed assets are estimated at £1,600 per month.
- (g) Blair intends to make monthly cash drawings of £1,000.

Prepare the monthly cash budget for the six months to 31st Mar 2000.

Question 6

Prepare a cash budget for N. Morris showing the balance at the end of each month, from the following information for the six months ending 31st Dec 1999.

- Opening cash (including bank) balance £1,200
- Estimated production in units.

1999	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan
	240	270	300	320	350	370	380	340	310	260

Raw materials used in production cost £5 per unit. Of this 80% is paid in the month of production and 20% in the month after production.

- Direct labour costs £8 per unit and is payable in the month of production.
Variable expenses are £2 per unit, payable ½ in the same month of production and ½ in the month following production.

- Sales are £20 p.u.

1999	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
	260	200	320	290	400	300	350	400	390	400

Debtors pay their accounts three months after that in which the sales are made.

- Fixed expenses of £400 per month are payable each month.
- Machinery costing £2,000 to be paid in October.
- Morris will receive a legacy of £2,500 in December
- Drawings to be £300 per month.