Accounting
Building Business Skills

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Chapter Fifteen:
Budgeting

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Learning Objectives:

- Outline the benefits and essential elements of effective budgeting.
- Identify and describe the componenets of the master budget.
- Describe the sources for preparing the budgeted statement of financial performance.

2

Learning Objectives:

- Explain and prepare the main sections of a cash budget.
- Indicate the applicability of budgeting in non-manufacturing entities.
- Explain the concept of budgetary control.

3

Learning Objectives:

- Compare and contrast the use of static and flexible budgets.
- Describe the concept of responsibility accounting.
- Identify the content of responsibility reports and their use in performance evaluation.

4

Budgeting Basics

- Budget – formal written statement of management's plan for specified future time period, expressed in financial terms
- Used for planning and control
- Planning – establishing short-term and long-term objectives
- Control – ensuring objectives are met

5

Budgeting Basics

- Budgeting and accounting – accounting used to express budgetary goals in financial terms:
  - uses historical data on revenues, costs and expenses
  - periodic reports prepared
  - management uses reports for comparing actual results to planned objectives

6

Budgeting Basics

- Benefits – requires management to plan ahead:
  - definite financial objectives for all levels of responsibility
  - early warning system for problems
  - coordination of activities
  - management awareness of operations and external factors
  - motivation towards positive behaviour patterns

7

Budgeting Basics

- Essentials – for effective budgeting:
  - clearly defined areas of authority and responsibility
  - realistic goals
  - acceptance by all levels of management
  - participation by managers in setting budgets
  - review of differences between actual and expected results

8

Budgeting Basics

- Budget period – usually for one year
  - may vary according to need
- Process – begins before end of current year
  - starts with sales forecast
- Long-range planning (3-5 years):
  - strategic focus
  - budgets usually just 1 year, and much more detailed

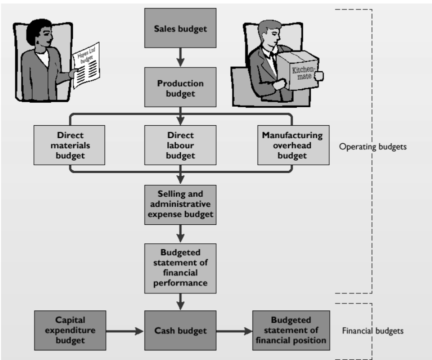
9

Budgeting Basics

- Master budget – set of interrelated budgets:
  - operating budgets (sales and production) lead to budgeted statement of financial performance
  - financial budgets (cash budget and budgeted statement of financial position) concern cash resources for expected operations and capital expenditure

10

Budgeting Basics



Preparing Operating Budgets

- Sales budget – based on forecast of sales revenue for budget period
  - starting point for master budget
  - expected unit sales volume times anticipated unit selling price
  - sets activity levels for other functions (e.g. production, purchasing)

12

Preparing Operating Budgets

- Production budget – units to be produced in order to meet expected sales
  - involves realistic estimates in order to avoid insufficient or excessive ending inventory

13

Preparing Operating Budgets

- leads to budgets for each manufacturing cost element

Budgeted sales units + Desired ending finished goods units – Beginning finished goods units = Required production units

14

Preparing Operating Budgets

- Direct Materials budget – for quantity and cost of materials to be purchased
  - required units of material (from production budget) times anticipated cost per unit

15

Preparing Operating Budgets

– also involves realistic estimate of desired ending inventory

Direct materials units required for production + Desired ending direct materials units – Beginning direct materials units = Required purchases of direct materials units

16

Preparing Operating Budgets

- Direct Labour budget – for quantity (hours) and cost of labour needed for production requirements
  - required labour hours (from production budget) times anticipated hourly wage rate
  - involves realistic estimates of labour force required for anticipated level of production activity

17

Preparing Operating Budgets

- Manufacturing Overhead budget – may distinguish between variable and fixed overhead costs
  - variable overhead costs fluctuate with changes to production volume
  - total fixed overhead costs are estimated, then divided by cost driver to establish per-unit rate to be applied to production

18

Preparing Operating Budgets

- Selling and administration expense budget – may also distinguish between variable and fixed expenses
  - variable expenses based on budgeted unit sales
  - fixed expenses based on assumed costs for period

19

Preparing Operating Budgets

- Budgeted statement of financial performance – end-point of operating budgets
  - shows expected profitability for budget period
  - combines individual operating budgets plus additional expenses (e.g. interest, taxes)
  - forms basis for performance evaluation

20

Preparing Financial Budgets

- Cash budget – three sections:
  - cash receipts: expected cash inflows from customers, interest, dividends, planned sales of assets and shares
  - cash payments: expected cash outflows for direct materials and labour, overheads, selling & administration costs, taxes, dividends, assets
  - financing: expected cash borrowings and repayments of borrowings

21

Preparing Financial Budgets

- Cash budget combines ending cash balance from previous period plus details from other budgets
  - annual cash budget often detailed on monthly basis to reflect anticipated levels of activities
  - helps plan for cash excesses and shortfalls

22

Preparing Financial Budgets

- Budgeted statement of financial position – projected financial position at end of budget period
  - combines previous period's budgeted financial position and budgets for current period (sales, direct materials, direct labour, overheads, selling and administration budgets)
  - similar format to that prepared for external users

23

Non-Manufacturing Entities

- Merchandising entities – sales budget drives master budget
  - master budget incorporates departmental budgets
  - purchases budget used instead of production budget
  - purchases budget shows estimated cost of goods needed to meet sales

24

Non-Manufacturing Entities

- manufacturing budget (for materials, labour, overheads) not used

Budgeted cost of goods sold + Desired ending inventory – Beginning inventory = Required purchases

25

Non-Manufacturing Entities

- Service entities – expected output drives master budget
  - levels of staff planned to match anticipated levels of service
  - profitability affected by overstaffing (excessive labour costs) and understaffing (client dissatisfaction thus low revenue)
  - service revenue determined by billing time and services offered

26

Non-Manufacturing Entities

- Not-for-profit entities – planned expenditure to fund activity index usually drives master budget
  - often budget prepared on cash basis, not accrual
  - management task is to find sufficient cash receipts for planned expenditure

27

Non-Manufacturing Entities

- Government entities – planned expenditure to cover various programs drives master budget
  - revenues come from taxes, rates or user-pays service charges
  - some assets obtained as part of private developments

28

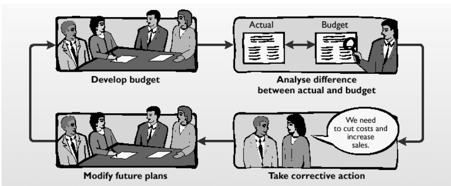
Budgeting Control

- Use of budgets to control operations by comparing actual results with planned objectives
  - at regular intervals: daily, weekly or monthly as required
- Provides feedback about progress of planned activities

29

Budgeting Control

- Differences analysed so plans can be modified if necessary



30

Budgeting Control

- Static budget reports – reflect one level of activity only
  - actual results compared with anticipated level of activity
  - unfavourable (U) results: actual revenue below or actual expenses above targets
  - favourable (F) results: actual revenue above or actual expenses below targets

31

Budgeting Control

- management determines significance (materiality) of differences
- investigation of reasons for U or F differences
- appropriate corrective actions depend on causes for differences
- may not be appropriate for performance evaluation (differing activity levels from master budget or costs changing for various activity levels)

32

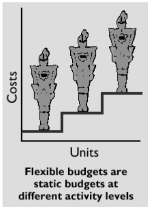
Budgeting Control

- Flexible budgets – reflect various levels of activity
  - master budget adapts to changing operating conditions
  - fixed costs do not change as activity levels change

33

Budgeting Control

– total variable costs do change as per-unit activities change



34

Budgeting Control

- Developing the flexible budget –
  - identify activity index and relevant range
  - identify variable costs and budgeted costs per unit
  - identify fixed costs and establish budgeted amounts
  - prepare budget for selected levels of activity within relevant range

35

Budgeting Control

- Flexible budget reports – two sections for analysing production and cost control:
  - production data (e.g. direct labour hours)
  - cost data (for fixed and variable costs)
  - both actual and budgeted costs are based on same activity level

36

Budgeting Control

- Management by exception – budget reports reviewed when actual and budgeted results differ significantly
  - management focus on problem areas
  - guidelines needed to identify level of significance
  - materiality: variance from budget by more than a predetermined amount
  - controllability: ability of manager to influence item

37

Responsibility Accounting

- Accumulating and reporting costs and revenues according to managers with authority to make decisions concerning the items
  - personalises management accounting systems
  - performance reports relate only to controllable items
  - effectiveness can be measured and reported at all management levels

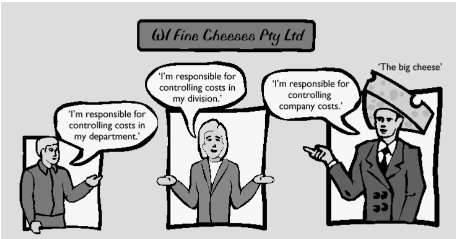
38

Responsibility Accounting

- Decentralised business – control delegated to many throughout organisation
  - segment: area of responsibility within decentralised organisation
  - each manager prepares regular reports for own area of responsibility

39

Responsibility Accounting



Responsibility accounting gives managers responsibility for *controllable costs* at each level of authority

40

Responsibility Accounting

- Controllability – cost or revenue item must be controllable at some level of responsibility
  - – all costs controllable at the top
  - – costs less controllable as move down through levels of management
  - – direct costs generally controllable in areas where incurred
  - – indirect costs generally allocated and are not controllable

41

Responsibility Accounting

- Responsibility reporting system – reports prepared for each area of responsibility
  - – starts at lowest level of responsibility
  - – collated and summarised as progress upwards through levels of responsibility
  - – costs and revenues identified as controllable at appropriate levels
  - – management by exception possible at each level

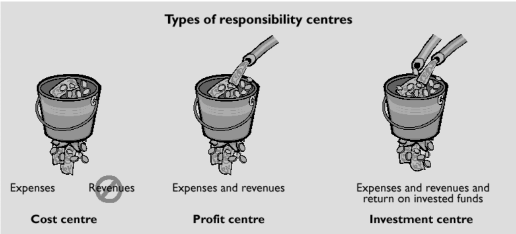
42

Types of Responsibility Centres

- Cost centres – no directly generated revenues
  - performance evaluated by comparing actual controllable costs to flexible budget data
  - no distinction between fixed and variable costs
  - controllability is key issue
  - usually production departments or service centres

43

Types of Responsibility Centres



44

Types of Responsibility Centres

- Profit centres – revenues generated plus costs incurred
  - managers evaluated on profitability
  - fixed costs may be direct or indirect
  - direct fixed costs: traceable to responsibility centre, and often controllable
  - indirect fixed costs: allocated to profit centres, and are not controllable

45

Types of Responsibility Centres

- Profit centre responsibility reports – include items of profitability
  - – contribution margin less controllable fixed costs
  - – controllable margin gives measure of manager's performance
  - – performance evaluated on ability to control revenues and costs
  - – non-controllable fixed costs not reported

46

Types of Responsibility Centres

- Investment centres – manager can control or influence investment funds
  - – usual measure is return on investment (ROI)
  - – manager controls operating assets (current assets plus property, plant and equipment)

47

Types of Responsibility Centres

– idle assets are excluded

Investment centre controllable margin (in dollars)	÷	Average investment centre operating assets	=	Return on investment (ROI)
$1 000 000	÷	$5 000 000	=	20%

48

Types of Responsibility Centres

- Investment centre responsibility reports – include budgeted and actual ROI below controllable margin
  - affected by extent of manager's responsibility
  - is independent of operations, so fixed costs are controllable and included
  - issues of valuation of assets affect reports
  - also which profitability measure is used

49

Types of Responsibility Centres

- Principles of performance evaluation – based on actual results compared to budgeted goals
  - involvement of managers in setting budget goals
  - evaluation of performance based only on controllable items
  - support of top management for evaluation process

50

Types of Responsibility Centres

  - identification of both good and poor performance
  - use of accurate and reliable budget data
  - highlight significant differences between actual and budget results
  - regular and reasonable reporting intervals
  - reports designed for intended purposes

51