Chapter 11

BUDGETING

1. Introduction

Budgeting is an essential tool for the management accounting in both planning and controlling future activity. In this chapter we will discuss the benefits of budgeting, the types of budget, and the preparation of budgets.

2. Benefits of budgeting

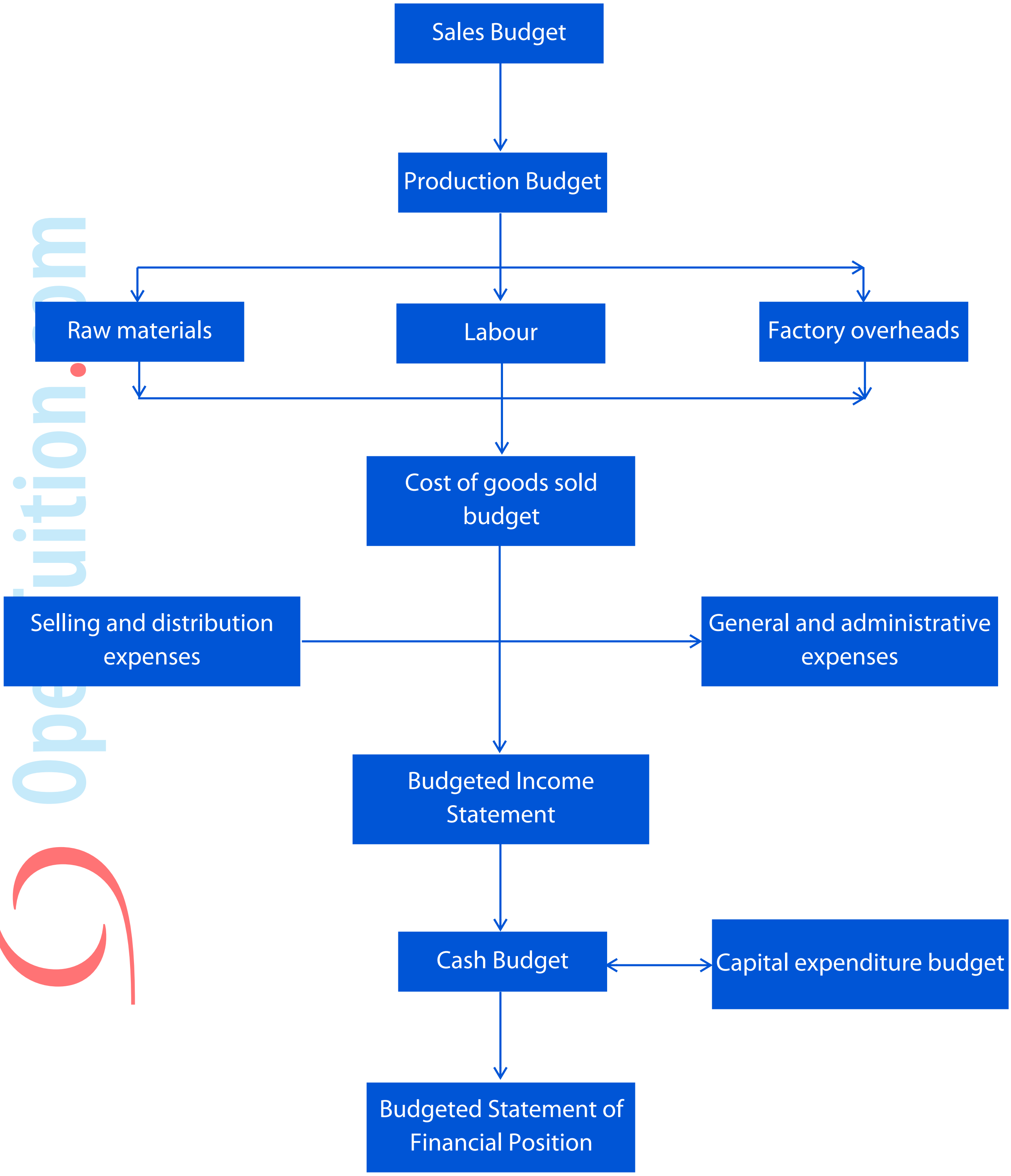
- Planning
- Co-ordination
- Control
- Authorising and delegating
- Evaluation of performance
- Communicating and motivating

3. Principal budget factor

The principal budget factor is the factor that limits the activity for the budget period. Normally this is the level of sales and therefore the sales budget is usually the first budget to be prepared and this leads to the others.

However, it could be (for example) a limit on the availability of raw materials that limits activity. In this case Raw Materials would be the principal budget factor, and this would the first budget to be prepared.

4. The preparation of budgets



Example 1

The XYZ company produces three products, X, Y, and Z. For the coming accounting period budgets are to be prepared using the following information:

Budgeted sales

Product X	2000 units at $100 each
Product Y	4000 units at $130 each
Product Z	3000 units at $150 each

Standard usage of raw material

	Wood *(kg per unit)*	*Varnish* *(litres per unit)*
Product X	5	2
Product Y	3	2
Product Z	2	1
Standard cost of raw material	$8	$4

Inventories of finished goods

	X	*Y*	*Z*
Opening	500u	800u	700u
Closing	600u	1000u	800u

Inventories of raw materials

	Wood	*Varnish*
Opening	21,000	10,000
Closing	18,000	9,000

Labour

	X	*Y*	*Z*
Standard hours per unit	4	6	8

Labour is paid at the rate of $3 per hour

Prepare the following budgets:

(a) Sales budget (quantity and value)

(b) Production budget (units)

(c) Material usage budget (quantities)

(d) Material purchases budget (quantities and value)

(e) Labour budget (hours and value)

5. Types of budget

- **Fixed budget**

- **Flexed budget**

- **Rolling budget**

Example 2

A company has prepared the following fixed budget for the coming year.

Sales	10,000 units
Production	10,000 units

	$
Direct materials	50,000
Direct labour	25,000
Variable overheads	12,500
Fixed overheads	10,000
	$97,500

Budgeted selling price $10 per unit.

At the end of the year, the following costs had been incurred for the actual production of 12,000 units.

	$
Direct materials	60,000
Direct labour	28,500
Variable overheads	15,000
Fixed overheads	11,000
	$114,500

The actual sales were 12,000 units for $122,000

(a) Prepare a flexed budget for the actual activity for the year

(b) Calculate the variances between actual and flexed budget, and summarise in a form suitable for management. (Use a marginal costing approach)

6. Methods of budgeting

6.1. Incremental budgeting

This approach is to take the previous years results and then to adjust them by an amount to cover inflation and any other known changes.

It is the most common approach, is a reasonably quick approach, and for stable companies it tends to be fairly accurate.

However, one large potential problem is that it can encourage the continuation of previous problems and inefficiencies.

The reason for this is that the budget is a plan for the coming year – not simply a financial forecast.

If we require a wages budget, we will probably ask the wages department to produce it and they (using an incremental approach) will assume that our workers will continue to operate as before. They will therefore simply adjust by any expected wage increases.

As a result, the 'plan' for our workers stays the same as before. Nobody has been encouraged to consider different ways of operating that may be more efficient. It is at budget time that we perhaps should be considering different ways of operating.

6.2. Zero-based budgeting

With zero-based budgeting we do not consider the previous period. Instead, we consider each activity on its own merits and draw up the costs and benefits of the different ways of performing it (and indeed whether or not the activity should continue).

We then decide on the most effective way of performing each activity.

Clearly any changes to the way an activity is performed may require funding, and there may not be sufficient funding available for all changes proposed, and therefore they are ranked to decide which changes are made.

Although this approach is in principle a much better approach to budgeting, it is time-consuming and also requires much more expertise than incremental budgeting. For this reason, it is often restricted just to a few activities each year in order that training and help may be given to the people involved. Other activities are budgeted using the incremental approach.

7. Behavioural aspects

7.1. Participation

If the budget process is not handled properly, it can easily cause dysfunctional activity. It is therefore necessary to give thought to the behavioural aspects.

- **Top-down budgeting**

  This is where budgets are imposed by top management without the participation of the people who will actually be involved for implementing it.

- **Bottom-up budgeting**

  Here the budget-holders do participate in the setting of their own budgets.

- **Advantages and disadvantages**

7.2. Target setting and motivation

Targets can assist motivation and appraisal if they are set at the right level.

- if they are too difficult then they will demotivate
- if they are too easy then managers are less likely to strive for optimal performance
- ideally they should be slightly above the anticipated performance level

Good targets should be:

- agreed in advance
- dependant on factors controllable by the individual
- measurable
- linked to appropriate rewards and penalties
- chosen carefully to ensure goal congruence

7.3. Responsibility accounting

A system of accounting that separates revenues and costs into areas of separate responsibility, which can then be assigned to specific managers

7.4. Management by objectives

A system of management incorporating clearly established objectives at every level of the organisation.

Here there is less emphasis on monetary budgets and more emphasis on taking action which helps the business to achieve its objectives.

When you finished this chapter you should attempt the online F5 MCQ Test