Chapter 11 revision notes

Planning and budgeting

Budgeting, planning and control

The long-term (strategic) and short-term (budget) planning processes are core management tasks that are critically important to the future survival and success of the business. The budget prepared for planning purposes, as part of the strategic planning process, is the quantitative plan of management's belief of what the business's costs and revenues will be over a specific future period. The budget prepared for control purposes, which may have been based on standards that may not be reached, is used for motivational purposes to influence improved departmental performance. Monitoring of actual performance against the budget is used to provide feedback in order take the appropriate action necessary to reach planned performance, and to revise plans in the light of changes.

Strategic planning

Strategic planning is the process of deciding:

- on the objectives of the organisation
- on changes in these objectives
- on the resources used to attain these objectives
- on the policies that are to govern the acquisition, use and disposition of these resources

It is not correct to assume that strategic planning is just an extension of budgeting, but there is a close relationship between these processes. A budget is a quantified statement, for a defined period of time, which may include planned revenues, expenses, assets, liabilities and cash flows. A budget provides a focus for the organisation, aids the co-ordination of activities, and facilitates control.

Budgeting

A budget is a plan and budgeting is one part of the strategic planning process, which is concerned with planning and control.

The broad purposes of budgeting include:

- planning and control
- co-ordination
- communication
- motivation and alignment of individual and corporate goals
- evaluation of performance

Budgetary control establishes a basis for internal audit by regularly evaluating departmental results. The budget process should ensure that scarce resources are allocated in an optimal way, and so enable expenditure to be controlled. Management is forced to plan ahead so that long-term goals are achieved.

The budget provides a yardstick for performance rather than rely on past periods comparisons, since when conditions and expectations will have changed. Areas of efficiency and inefficiency are identified through reporting of variances, and variance analysis will prompt remedial action where necessary. Part of the budget process should identify the people responsible for items of cost and revenue so that areas of responsibility are clearly defined.

Planning

Planning budgets are management's belief of what the business's costs and revenues will be over a specified future time period, the budget period.

Planning and control are two of the most visible ways that financial and non-financial information may be used in the management control process. This is done by:

- setting standards of performance and providing feedback, and therefore
- identifying areas for improvement, by means of
- variance reports

Control

Control budgets are used for management motivational purposes and in this way influence improved departmental performance.

Control and monitoring are the continuous comparison of actual results with those planned, both in total, and for the separate divisions within the organisation, and taking management action to correct adverse variances and to exploit favourable variances.
Management control is the process by which managers assure that resources are obtained and used effectively and efficiently in the accomplishment of the organisation's objectives.
Operational control is concerned with day-to-day activities of organisations, and is the process of assuring that specific tasks are carried out effectively and efficiently.
Whereas planning is achieved by means of a fixed master budget, control is generally exercised through the comparison of actual costs with a flexible budget. A flexible budget is a budget, which, by recognising different cost behaviour patterns, is designed to show changes in variable costs as the volume of activity of the organisation changes. Over the short timespans that budgets normally cover (one year or six months), fixed costs are assumed to remain unchanged.

Forecasting and planning

Forecasts are not plans but predictions of the future, which are required as an important prerequisite to the budget process.
The budget is a plan.
A forecast is not a budget but a prediction of future environments, events, and outcomes. Forecasting should start with projected sales volumes/market share, of current and new products.
Forecasting usually relies on the analysis of past data to identify patterns used to describe it. Patterns may then be extrapolated into the future to prepare a forecast. There are many forecasting methods, qualitative and quantitative, with no one best model. It is usually a question of fitting the pattern of historical data to the model that best fits.

Qualitative forecasting

Qualitative forecasting uses expert opinion to predict future events and includes:

- the Delphi method – panel of recognised experts
- technological comparisons – independent forecasters predicting changes in one area by monitoring changes in another area
- subjective curve fitting – for example similar product life cycles for similar products like CD players and mini disc player

Quantitative forecasting

Quantitative forecasting uses historical data to try and predict the future, and includes univariate models and causal models. Univariate models predict future values of time series when conditions are expected to remain the same, for example exponential smoothing and the use of moving averages.
Causal models involve the use of the identification of other variables related to the variable being predicted. For example, linear regression may be used to forecast sales, using the independent variables of:

- sales price
- advertising expenditure
- competitors prices

Whichever forecasting method is used it is important that the basis and the methodology of the forecasting is understood. All assumptions made and the parameters of time, availability of past data, costs, accuracy required, and ease of use must be clearly stated to maintain any sort of confidence in the forecasts.

The budget process

Prior to budget preparation, in addition to forecasting, decisions must be made and policies formulated regarding stock days and purchasing, debtor and creditor days, staff costs, capital expenditure, and standard costs.
The master profit and loss budget is prepared from each of the elements of the operating budget: sales; production; distribution and administration, and the financial budget.
The master budget is comprised of the profit and loss budget, cash budget, and balance sheet budget.

Sales and gross margin budget

Once the sales forecast has been prepared the budgeted gross margin may be calculated. The budgeted gross margin is derived from estimated:

- sales volumes
- current material costs

- standard labour
- overhead rates

Production budget

The production budget may be prepared allowing for expected stock movements in the period, based on company policy and targets for improvement. Budgeted materials requirements are based on a bill of materials (BOM), which is the 'list of ingredients and recipe' for each product. The purchasing function ensures that the right materials, components and packaging are procured in the right quantities, at the right time to the right location, in line with production and stockholding requirements.

Budgeted labour requirements are based on standard labour hours required for each product.

Depreciation charged to production overhead is calculated based on existing plant and equipment and the plans for new plant and equipment that have been submitted by managers responsible for production and production support activities.

Distribution and administration budget

The below-the-line overhead costs of:

- marketing and selling
- distribution
- administration
- research and development

and also planned capital expenditure are provided by managers responsible for such departments as:

- commercial and marketing
- finance
- information technology
- administration
- human resources
- engineering
- product development

Financial budget

Costs of financing and/or interest receivable from the investment of surplus funds may be estimated for the first draft budget. As the phased profit and loss account, capital expenditure and cash budget become finalised the financial budget can be refined with a little more accuracy.

Master profit and loss budget

The master budget is prepared by pulling together each of the elements outlined above to provide a budgeted:

- trading account
- manufacturing account
- profit and loss account

for the year.

Padding may occur where budget holders are allowed to be excessively prudent regarding costs and expenses or achievement of sales. Managers may be prudent when constructing their budgets, and this can take the form of putting a little extra into expense categories that may be difficult to verify, or a little less in certain categories or sales.

The budget preparation process is a continuous process of:

- setting objectives
- forecasting
- draft budget preparation
- evaluation
- feedback
- forecast and budget revisions

Cash budget

Cash flow is an extremely important element in the budget preparation process. The master profit and loss budget, together with the planned capital expenditure, the outflow of cash on fixed asset acquisitions and investments, may then be used to prepare an initial cash budget. This will also include the impact of the operating cycle.

The final cash budget, phased to show monthly cash surpluses or cash requirements, will also include the effect of non-operational events such as cash raised through the issue of shares and loans.

Balance sheet budget

The budget balance sheet may be prepared with reference to:

- information relating to sales, costs, etc., from the master profit and loss budget
- the capital expenditure budget
- operating cycle assumptions on stock days, debtor days, creditor days
- the cash budget

Funding requirements

The final budget should not be accepted until the projected financial position of the business has been reviewed in terms of the adequacy, or otherwise, of funding. Risk analysis and risk assessment is essential to be carried out on each of the uncertain areas of the budget, to determine any requirement for additional funding and safeguard the future of the business.

Additional funding may be by way of extended overdraft facilities, loans or additional share capital. The appropriate funding decision may be made and matched with the type of activity for which funding is required. For example, major capital expenditure projects would not be funded by an overdraft, but with longer-term funding in line with the nature of the project.

Performance evaluation and control

Control budgets are usually flexed to reflect actual activity levels, and performance against budget provided from exception reporting evaluated so that corrective actions may be implemented as appropriate.

Prior to budget preparation, targets may be issued, for example, for:

- sales
- gross margin
- return on investment
- stock days
- debtor collection days
- creditor payment days

Actual departmental results may then be regularly reported against control budgets that have had full acceptance by the relevant managers and based on up to date and realistic standards of performance.

The budget is used as a tool for control of the business by monitoring actual performance and comparing how closely it is in line with the plan. For this purpose the overall budget plan is broken down into the individual elements, representing the areas of responsibility of each of the budget holders, which are called responsibility centres.

Responsibility centres

A responsibility centre is a department or organisational function whose performance is the direct responsibility of a specific manager. Responsibility accounting is the system used to measure budget and actual results for each centre. Costs are traced to the activities causing them, or to the individuals knowledgeable about why they arose, and who authorised them

There are four main types of responsibilit centre:

- cost centre
- revenue centre
- profit centre
- investment centre

Responsibility must be matched with control, otherwise a manager is more likely to be demotivated. The manager must be able to influence the costs in question over specific time spans. Budget holders can onl be responsible for controllable costs or revenues within their areas of responsibility.

Motivation and the behavioural aspects of budgeting

The preparation of budgets for planning and control purposes needs the involvement of people to provide realistic plans and the motivation for performance targets to be achieved.

One of the main objectives of budgeting is to influence the behaviour of the people in the organisation so that efficiency is maximised and corporate goals are attained. Motivation is an important underlying factor in ensuring that achievable budgets are set and that the managers with the responsibility for each of the elements of the budget have a very good chance of achieving their objectives.

Key motivational factors include:

- pay
- bonuses
- feedback of information
- communication and discussion of control reports
- success, and reward for target achievement
- training in the budget process
- the identification of controllable and uncontrollable costs
- the setting of fair, achievable standards
- the avoidance of short run wins at the expense of long run considerations, leading to dysfunctional decision-making
- flexibility in meeting the requirements of the budgeting syste
- performance appraisal using budgets flexed to actual activity levels
- inclusion of non-financial performance indicators

Problems in budgeting

There are usually many conflicts and problems associated with the budget preparation process in most organisations, the majority of which are concerned with the 'softer' human resources issues of managers' behaviour.

Organisations can be very unforgiving when targets are not achieved. The budget preparation process has become easier to manage with the introduction of powerful IT resources; it has also resulted in more accuracy required within the estimates and also within a shorter timeframe.

It is essential that individual budget-holders 'buy-in' to their budgets to enable subsequent meaningful monitoring and evaluation of actual performance. Their budgets, whilst representing difficult-to-meet targets, must also be achievable to provide the necessary motivation to reach their goals.

Responsibility must be matched with control. Costs that should be considered uncontrollable, may not necessarily be treated as such in evaluating individual performance, resulting in discontent and de-motivation.

Performance against budgeted costs at the operating level should be flexed to reflect current activity.