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# MASTER BUDGETING

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## OUTLINE OF THE LECTURE

1. Budget
2. Advantages of budgeting
3. Choosing a budget period
4. The master budget
5. Preparing the master budget

## BUDGET (1)

- **a budget** is a detailed plan for the future that is usually expressed in formal quantitative terms
- once the budget is established, actual spending is compared to the budget to make sure the plan is being followed
- budgets are used for two distinct purposes - **planning** and **control**
- **planning** involves developing goals and preparing various budgets to achieve those goals

## BUDGET (2)

- **control** involves gathering feedback to ensure that the plan is being properly executed or modified as circumstance change
  - to be effective, a good budgeting system must provide for both planning and control
- good planning without effective control is a waste of time and effort

## ADVANTAGES OF BUDGETING (1)

- budgets ***communicate*** management's plans throughout the organization
- budgets force managers to ***think about*** and plan for the future. In the absence of the necessity to prepare a budget, many managers would spend all of their time dealing with day-to-day emergencies
- the budgeting process provides a means of ***allocating*** resources to those parts of the organization where they can be used most effectively

## ADVANTAGES OF BUDGETING (2)

- the budgeting process can uncover potential **bottlenecks** before they occur
- budgets coordinate the activities of the entire organization by **integrating** the plans of its various parts.
  - Budgeting helps to ensure that everyone in the organization is pulling in the same direction
- budgets define goals and objectives that can serve as **benchmarks** for evaluating subsequent performance

## RESPONSIBILITY ACCOUNTING

- the basic idea underlying **responsibility accounting** is that a manager should be held responsible for those items and only those items that manager can actually control to a significant extent
- each line item in the budget is the responsibility of a manager who is held responsible for subsequent deviations between budgeted goals and actual results
- in effect, responsibility accounting personalizes accounting information by holding individuals responsible for revenues and costs
- this concept is central to any effective planning and control system

## CHOOSING A BUDGET PERIOD (1)

- operating budgets ordinarily cover a one-year period corresponding to the company's fiscal year
- many companies divide their budget year into four quarters
- the first quarter is then subdivided into months, and monthly budgets are developed
- the last three quarters may be carried in the budget as quarterly totals only
- as the year progresses the figures for the second quarter are broken down into monthly amounts, then the third-quarter figures are broken down, and so forth



## CHOOSING A BUDGET PERIOD (2)

- this approach has the advantage of requiring periodic review and reappraisal of budget data throughout the year
- **continuous** or **perpetual budgets** are sometimes used
- **a continuous or perpetual budget** is a 12-month budget that rolls forward one month (or quarter) as the current month (or quarter) is completed
- in other words, one month (or quarter) is added to the end of the budget as each month (or quarter) comes to a close
- this approach keeps managers focused at least one year ahead so that they do not become too narrowly focused on short-term results

## THE SELF-IMPOSED BUDGET (1)

- many managers believe that being empowered to create their own self-imposed budgets is the most effective method of budget preparation
- a self-imposed budget or participative budget is a budget that is prepared with the full cooperation and participation of managers at all levels

### **THE SELF-IMPOSED BUDGET (2) – ADVANTAGES (1)**

- Individuals at all levels of the organization are recognized as members of the team whose views and judgments are valued by top management.
- Budget estimates prepared by front-line managers are often more accurate and reliable than estimates prepared by top managers who have less intimate knowledge of markets and day-to-day operations.
- Motivation is generally higher when individuals participate in setting their own goals than when the goals are imposed from above. Self-imposed budgets create commitment.

### THE SELF-IMPOSED BUDGET (3) – ADVANTAGES (2)

- A manager who is not able to meet a budget that has been imposed from above can always say that the budget was unrealistic and impossible to meet. With a self-imposed budget, this claim cannot be made.

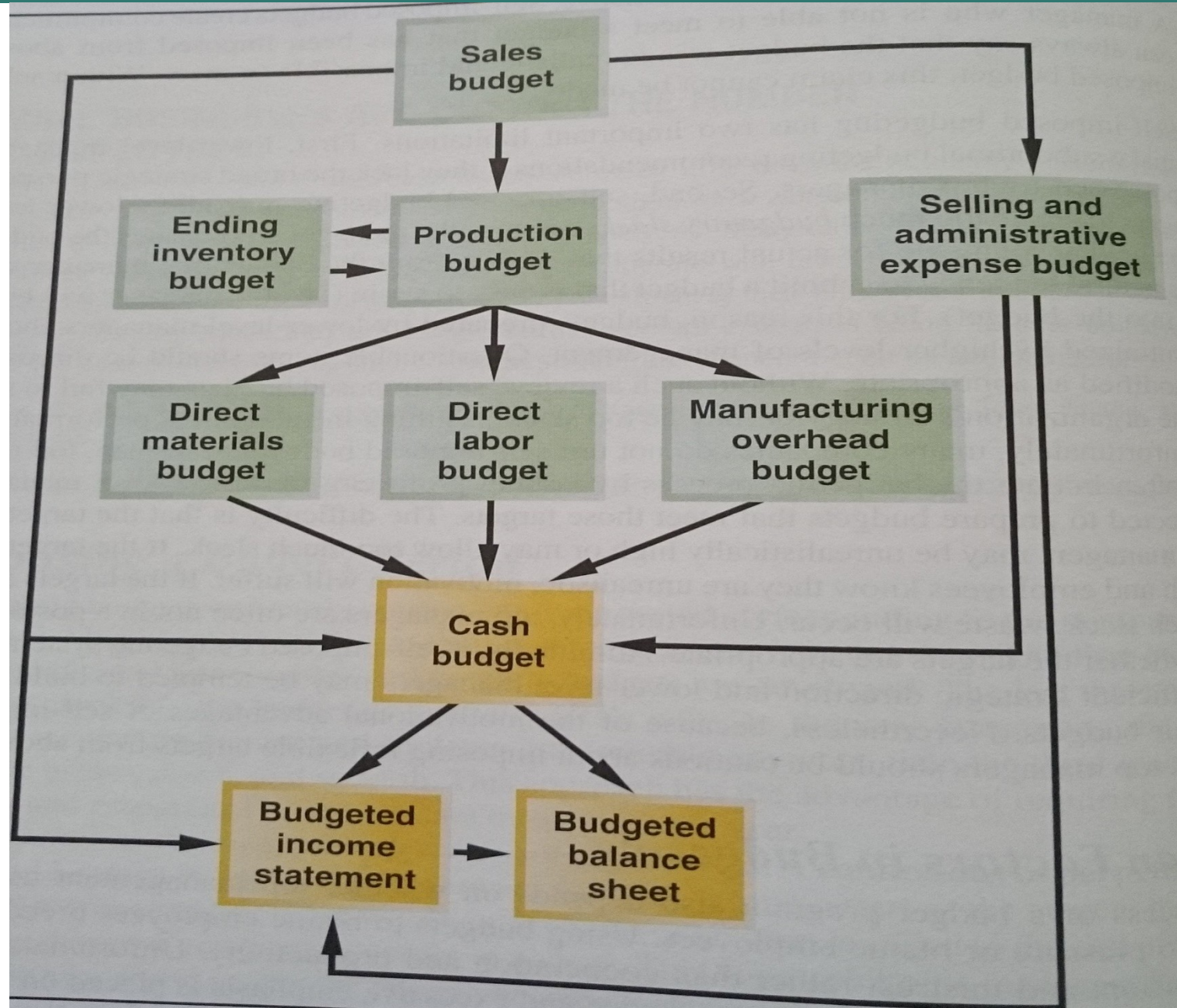
## THE SELF-IMPOSED BUDGET (3)

- self-imposed budgeting has two important limitations
  - lower-level managers may make suboptimal budgeting recommendations of they lack the broad strategic perspective possessed by top managers
  - self-imposed budgeting may allow lower-level managers to create too much budgetary slack
- because the manager who creates the budget will be held accountable for actual results that deviate from the budget, the manager will have a natural tendency to submit a budget that is easy to attain
- for this reason, budgets prepared by lower-level managers should be scrutinized by higher levels of management
  - many companies divide their budget year into four quarters

## THE MASTER BUDGET

- **the master budget** consists of a number of separate but interdependent budgets that formally lay out the company's sales, production, and financial goals
- the master budget culminates in a cash budget, a budgeted income statement, and a budgeted balance sheet

# MASTER BUDGETING



### THE MASTER BUDGET - SALES BUDGET (1)

- the first step in the budgeting process is the preparation of the sales budget, which is a detailed schedule showing the expected sales for the budget period
- an accurate sales budget is the key to the entire budgeting process
- all other parts of the master budget depend on the sales budget
- if the sales budget is inaccurate, the rest of the budget will be inaccurate
- the sales budget is based on the company's sales forecast



### THE MASTER BUDGET - SALES BUDGET (2)

- the sales budget influences the variable portion of the selling and administrative expense budget and it feeds into the production budget, which defines how many units need to be produced during the budget period
- the production budget in turn is used to determine the direct materials, direct labor, and manufacturing overhead budgets
- once a company has prepared these three manufacturing cost budgets, it can prepare the ending finished goods inventory budget

## THE MASTER BUDGET (3)

- the master budget concludes with the preparation of a cash budget, income statement, and balance sheet
- information from the sales budget, selling and administrative expense budget, and the manufacturing cost budgets all influence the preparation of the cash budget
- A cash budget is a detailed plan showing how cash resources will be acquired and used
- the budgeted income statement provides an estimate of net income for the budget period and it relies on information from the sales budget, ending finished goods inventory budget, selling administrative expense budget, and the cash budget

## THE MASTER BUDGET AND 10 KEY QUESTIONS

a master budget for a manufacturing company is designed to answer 10 key questions as follows:

1. How much sales revenue will we earn?
2. How much cash will we collect from customer?
3. How much raw material will we need to purchase?
4. How much manufacturing cost (including direct materials, direct labor, and manufacturing overhead) will we incur?
5. How much cash will we pay to our suppliers and our direct laborers, and how much will we pay for manufacturing overhead resources?
6. What is the total cost that will be transferred from finished goods inventory to cost of goods sold?
7. How much selling and administrative expense will we incur and how much cash will we pay related to those expenses?
8. How much money will we borrow from or repay to lenders - including interest?
9. How much net operating income will we earn?
10. What will our balance sheet look like at the end of the budget period?

## PREPARING THE MASTER BUDGET (1)

- **The production budget** is prepared after the sales budget. The production budget lists number of units that must be produced to satisfy sales needs and to provide for the desired ending finished goods inventory
- **A merchandise purposes budget** showing the amount of goods to be purchased from suppliers during the period
- **A direct materials budget** is prepared after the production requirements have been computed. The direct materials budget details the raw materials that must be purchased to fulfill the production budget and to provide for adequate inventories.

### PREPARING THE MASTER BUDGET (2)

- **The direct labor budget** shows the direct labor-hours required to satisfy the production budget. By knowing in advance how much labor time will be needed throughout the budget year, the company can develop plans to adjust the labor force as the situation requires.
- **The manufacturing overhead budget** list all costs of production other than direct materials and direct labor.
- The cost of unsold units is computed on **the ending finished goods inventory budget**.

### PREPARING THE MASTER BUDGET (3)

- **The selling and administrative expense budget** lists the budgeted expenses for areas other than manufacturing. In large organizations, this budget would be a compilation of many smaller, individual budgets submitted by department heads and other persons responsible for selling and administrative expenses.

## THE CASH BUDGET (1)

The cash budget is composed of four major sections:

- the receipts section
- the disbursements section
- the cash excess or deficiency section
- the financing section

## THE CASH BUDGET (2)

### **The receipts section**

- the receipts section lists all of the cash inflows, except from financing, expected during the budget period
- the major source of receipts is from sales

### **The disbursements section**

- the disbursements section summarizes all cash payments that are planned for the budget period
- these payments include raw materials purchases, direct labour payments, manufacturing overhead costs, and so on, as contained in their respective budgets



## THE CASH BUDGET (3)

### The cash excess or deficiency section

- if a cash deficiency exists during any budget period or if there is a cash excess during any budget period that is less than the minimum required cash balance, the company will need to borrow money
- if there is a cash excess during any budget period that is greater than the minimum required cash balance, the company can invest the excess funds or repay principal and interest to lenders

## THE CASH BUDGET (4)

### The financing section

- the financing section of the cash budget details the borrowings and principal and interest repayments projected to take place during the budget period
- to calculate borrowings and interest payments, you will need to pay attention to the company's desired minimum cash balance and to the terms of the company's loan agreement with the bank

The cash balances at both the beginning and end of the year may be adequate even though a serious cash deficit occurs at some point during the year. The cash budget should be broken down into time periods that are short enough to capture major fluctuations in cash balances. While a monthly cash budget is most common, some organizations budget cash on a weekly or even daily basis.