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BUDGETING FOR PROFIT PLANNING

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BUDGETING DEFINED

- A **master** (comprehensive) budget is a formal statement of management s expectation regarding sales, costs, output, and other financial transactions of the firm for the coming period.
- Simply put, a budget is a set of projected or planned financial statements.
- It consists basically of a pro-forma income statement, a pro-forma balance sheet, and a cash budget.
- A budget is a tool used for both planning and control.

BUDGETING DEFINED

- At the beginning of the period, the budget is a plan or standard; at the end of the period, it serves as a control device to help management measure its performance against the plan so that future performance may be improved.

THE STRUCTURE OF THE MASTER BUDGET

The master budget is a classified broadly into two categories:

- 1. The operational budget, reflecting the results of operating decisions
- 2. The financial budget, reflecting the financial decisions of the firm

THE OPERATING BUDGET CONSISTS OF:

1. Sales budget, including a computation of expected cash receipts
2. Production budget
3. Direct material budget, including computation of expected cash disbursements for materials
4. Direct labour budget
5. Factory overhead budget
6. Ending inventory budget
7. Selling and administrative expense budget
8. Budgeted income statement, which can be prepared in a traditional or contribution format

THE FINANCIAL BUDGET CONSISTS OF:

1. Cash budget
2. Budgeted balance sheet

THE MAJOR STEPS IN PREPARING THE MASTER BUDGET ARE:

1. Prepare a sales forecast.
2. Determine production volume.
3. Estimate manufacturing costs and operating expenses.
4. Determine cash flow and other financial effects.
5. Formulate projected financial statements.

THE SALES BUDGET

- The sales budget is the starting point in preparing the master budget, since estimated sales volume influences nearly all other items appearing throughout the master budget.

- The sales budget ordinarily indicates the quantity of each product expected to be sold.

THE SALES BUDGET

- Basically, there are three ways of making estimates for the sales budget:

- 1. Make a statistical forecast on the basis of an analysis of general business conditions, market conditions, and product growth curves.
- 2. Make an internal estimate by collecting the opinions of executives and salespersons.
- 3. Analyze the several factors that affect sales revenue and then predict the future behaviour of each of these factors.

THE SALES BUDGET

- After sales volume has been estimated, the sales budget is constructed by multiplying the expected sales in units by the expected unit sales price.

- Generally, the sales budget includes a computation of expected cash collections from credit sales, which will be used later for cash budgeting.

THE PRODUCTION BUDGET

- After sales are budgeted, the production budget can be demonstrated.

- The number or units expected to be manufactured to meet budgeted sales and inventory requirements is set forth in the production budget.

- The expected volume of production is determined by subtracting the estimated inventory at the beginning of the period from the sum of the units expected to be sold and the desired inventory at the end of the period.

THE DIRECT MATERIAL BUDGET

- When the level of production has been computed, a direct material budget should be constructed to show how much material will be required for production and how much material must be purchased to meet this production requirement.

- The purchase will depend on both expected usage of materials and inventory levels.

THE DIRECT MATERIAL BUDGET

- The formula for computation of the purchase is:

Purchase in units = Usage + desired ending material inventory units – Beginning inventory units

- The direct material budges is usually accompanied by a computation of expected cash payments for materials.

THE DIRECT LABOUR BUDGET

- The production requirements as set forth in the production budget also provide the starting point for the preparation of the direct labour budget.
- To compute direct labour requirements, expected production volume for each period is multiplied by the number of direct labour hours required to produce a single unit.
- The direct labour hours required to meet production requirements is then multiplied by the direct labour cost per hour to obtain budgeted total direct labour costs.

THE FACTORY OVERHEAD BUDGET

- The factory overhead budget should provide a schedule of all manufacturing costs other than direct materials and direct labour.

- Using the contribution approach to budgeting requires the development of a predetermined overhead rate for the variable portion of them factory overhead.

- In developing the cash budget, we must remember that depreciation does not entail a cash outlay and therefore must be deducted from the total factory overhead in computing cash disbursements for factory overhead.

THE ENDING INVENTORY BUDGET

- The desired ending inventory budget provides us with the information required for the construction of budgeted financial statements.
- Specifically, it will help compute the cost of goods sold on the budgeted income statement.
- Second, it will give the dollar value of the ending materials and finished goods inventory to appear on the budgeted balance sheet.

THE SELLING AND ADMINISTRATIVE EXPENSE BUDGET

- The selling and administrative expense budget lists the operating expenses involved in selling the products and in managing the business.
- In order to complete the budgeted income statement in contribution format, variable selling and administrative expenses per unit must be computed.

THE CASH BUDGET

- The cash budget is prepared for the purpose of cash planning and control.
- It presents the expected cash inflow and outflow for a designated time period.
- The cash budget helps management keep cash balances in reasonable relationship to its needs.
- It aids in avoiding unnecessary idle cash and possible cash shortages.

THE CASH BUDGET

- The cash budget consists typically of four major sections:
- 1. The receipts section, which is the beginning cash balance, cash collections from customers, and other receipts
- 2. The disbursements section, which comprises all cash payments made by purpose
- 3. The cash surplus or deficit section, which simply shows the difference between the cash receipts section and the cash disbursements section
- 4. The financing section, which provides a detailed account of the borrowings and repayments expected during the budgeting period

THE BUDGETED INCOME STATEMENT

- The budgeted income statement summarizes the various component projections of revenue and expenses for the budgeting period.

- However, for control purposes the budget can be divided into quarters or even months, depending on the need.

THE BUDGETED BALANCE SHEET

- The budgeted balance sheet is developed by beginning with the balance sheet for the year just ended and adjusting it, using all the activities that are expected to take place during the budgeting period.

THE BUDGETED BALANCE SHEET

- Some of the reasons why the budgeted balance sheet must be prepared are:
- \- It could disclose some unfavourable finance conditions that management might want to avoid
- \- It serves as a final check on the mathematical accuracy of all the other budgets
- \- It helps management perform a variety of ratio calculations
- \- It highlights future resources and obligations

ZERO-BASE BUDGETING

- Zero-base budgeting is a planning and budgeting tool that uses cost-benefit analysis of projects and functions to improve resource allocation in an organization.

- Traditional budgeting tends to concentrate on the incremental change from the previous year.

- It assumes that the previous year s activities are essential and must be continued.

- Under zero-base budgeting, however, cost estimates are built up from scratch, from the zero level, and must be justified.

ZERO-BASE BUDGETING

- The basic steps to effective zero-base budgeting are:
- - Describe each organization s activity in a decision package
- - Analyse, evaluate, and rank all these packages in priority on the basis of cost-benefit analysis
- - Allocate resources accordingly

Thank you for your attention.