
Theme 2: Managing business activities

Chapter 33 and 34 – March, 2017

BUDGETS

PURPOSE OF BUDGETS

- ▶ *budget*: financial plan that is agreed in advance
- ▶ budget \neq forecast !
- ▶ in general, budgets are set up for 12 months and coincide with the *accounting year*
- ▶ *purposes of budgets*:
 - ▶ *control and monitoring*: helps management to control the business (set objectives & targets, compare results with budget)
 - ▶ *planning*: forces managers to anticipate problems and their solutions
 - ▶ *co-ordination*: large businesses \rightarrow many departments
 - ▶ *communication*: highlights the priorities of a business, removes *uncertainties within decision-making*
 - ▶ *efficiency*: budgeting gives financial control to lower levels of hierarchy
 - ▶ *motivation*: improving budget position is an indication of success for a department

BUDGETS

TYPES OF BUDGET

- ▶ Two key types of budget:
 1. sales budget
 2. production cost budget
- ▶ Budgets are made using *historical figures + anticipated future events*

BUDGETS

TYPES OF BUDGET

Budgets are made using *historical data* (in red: see worked example in book)

- ▶ *sales volume*: planned sales levels
- ▶ *sales revenue*: uses sales *volume* & *prices* to show planned production costs
- ▶ *production cost*: planned production costs (based on sales volume budget)
- ▶ *overheads*: planned indirect costs (i.e., insurance, rent)
- ▶ *total cost*: planned business costs
- ▶ *marketing*: planned spending on research, advertising, promotion, sales
- ▶ *R&D*: planned expenditure in R&D
- ▶ *profit*: planned revenue, costs, and profit
- ▶ *cash*: planned cash inflows & outflows
- ▶ *master*: summary of all budgets, cost, revenue, and profit

BUDGETS

TYPES OF BUDGET (WORKED EXAMPLE)

- ▶ Sales volume budget for *Emerald Artwork*

	Feb	Mar	Apr	May
AD23	100	100	100	100
AD24	50	80	80	100
AE12	40	50	40	50
AE13	30	30	50	50

- ▶ Company produces 4 products: AD23, AD24, AE12, and AE13
- ▶ Prices for AD23, AD24, AE12, and AE13 are £ 12, £ 20, £ 25, and £ 30, respectively
- ▶ Planned sales revenue budget:

	(£)			
	Feb	Mar	Apr	May
AD23	1,200 (12 × 100)	1,200 (12 × 100)	1,200 (12 × 100)	1,200 (12 × 100)
AD24	1,000 (20 × 50)	1,600 (20 × 80)	1,600 (20 × 80)	2,000 (20 × 100)
AE12	1,000 (25 × 40)	1,250 (25 × 50)	1,000 (25 × 40)	1,250 (25 × 50)
AE13	900 (30 × 30)	900 (30 × 30)	1,500 (30 × 50)	1,500 (30 × 50)
Total	4,100	4,950	5,300	5,950

BUDGETS

TYPES OF BUDGET (WORKED EXAMPLE)

► Production costs for *Emerald Artwork*

	(€)			
	FEB	MAR	APR	MAY
Cost of materials	660	780	810	900
(€3 per unit)	(3 × 220)	(3 × 260)	(3 × 270)	(3 × 300)
Direct labour costs	880	1,040	1,080	1,200
(€4 per unit)	(4 × 220)	(4 × 260)	(4 × 270)	(4 × 300)
Indirect labour costs	440	520	540	600
(€2 per unit)	(2 × 220)	(2 × 260)	(2 × 270)	(2 × 300)
Production overheads				
(10% of direct & indirect costs)	1,320 × 10% = 132	1,560 × 10% = 156	1,620 × 10% = 162	1,800 × 10% = 180
Total	2,112	2,496	2,592	2,880

BUDGETS

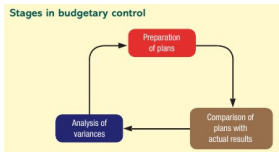
TYPES OF BUDGET

- ▶ *zero-based budget*: is not based on the variances of budgets from historical values
- ▶ a manager will have to show for each item of a category that the spending will generate a benefit
- ▶ *Advantages of ZBB*:
 - ▶ improves *allocation of resources*
 - ▶ *question attitude* → reduce unnecessary costs + inefficiencies
 - ▶ *staff motivation* → ZBB goes hand in hand with evaluation skills
 - ▶ encourages managers to look for alternatives
- ▶ *Disadvantages of ZBB*:
 - ▶ time-consuming
 - ▶ requires skilful decision-making

BUDGETS

USING BUDGETS: *budgetary control*

- ▶ preparation of plans: compare *targets* to *results achieved*
- ▶ comparisons of plans with actual results: evaluate *budgetary data* (within control periods)
- ▶ analysis of variances: explaining the differences between *actual* and *expected* financial outcomes



BUDGETS

VARIANCES

- ▶ *variance in budgeting*: difference between the value that has been *budgeted* and the *actual* figure
- ▶ variances can be:
 1. *favourable* (F) → actual figures are better than the budgeted ones
 2. *adverse* (A) → actual figure are worse than the budgeted ones

BUDGETS

TYPES OF VARIANCE

- ▶ budgets are set for *expenditure* (costs) and *income* (sales revenue)
- ▶ *variance analysis* is a good way to monitor business costs
- ▶ *sales variance*
- ▶ *profit variance*

BUDGETS

INCOME, EXPENDITURE, AND PROFIT VARIANCES

	(£)						
	Jan	Feb	Mar	Apr	May	Jun	Total
Budgeted income	16,500	17,000	17,500	18,000	19,000	20,000	108,000
Actual income	16,600	17,400	17,900	17,700	18,500	20,800	108,900
Variance	100F	400F	400F	300A	500A	800F	900F

	(£)						
	Jan	Feb	Mar	Apr	May	Jun	Total
Budgeted expenditure	11,400	11,900	12,500	13,000	14,000	15,000	77,800
Actual expenditure	11,500	11,600	12,700	13,500	14,200	15,600	79,100
Expenditure variances	100A	300F	200A	500A	200A	600A	1,300A

	(£)						
	Jan	Feb	Mar	Apr	May	Jun	Total
Budgeted profit	5,100	5,100	5,000	5,000	5,000	5,000	30,200
Actual profit	5,100	5,800	5,200	4,200	4,300	5,200	29,800
Profit variances	0	700F	200F	800A	700A	200F	400A

BUDGETS

USING VARIANCES FOR DECISION MAKING

- ▶ if variances are *adverse*:
 - ▶ actions can be taken to avoid this in future
- ▶ if variances are *favourable*:
 - ▶ strategies and systems can be used to maintain this performance

BUDGETS

DIFFICULTIES OF BUDGETING

- ▶ *setting budgets*: actual data may not be available or not used (i.e., historical data, forecast, human judgement may be used instead), inaccurate sales data, conflicts between departments, resource intensive (i.e., time consuming activity)
- ▶ *motivation*: workers may be left out of the planning process
- ▶ *manipulation*: budgets can be manipulated by managers
- ▶ *rigidity*: business activities may be constrained (i.e., replacing delivery vehicles)
- ▶ *short-termism*: managers may be focused on short-term targets (i.e., reducing staff, ...)

BUDGETS

CASE STUDY: BUYAMOTORJON.COM



BUDGETS

KEY TERMS

- ▶ budget:
- ▶ budgetary control:
- ▶ historical figures:
- ▶ production cost budget:
- ▶ sales budget:
- ▶ variances:
- ▶ variance analysis:
- ▶ zero-based budgeting or zero budgeting:

PROFIT

- ▶ gross profit:

$$\text{gross profit} = \text{revenue} - \text{cost of sales}$$

- ▶ operating profit:

$$\text{operating profit} = \text{gross profit} - \text{operating expenses}$$

- ▶ profit for the year (net profit):

PROFIT

STATEMENT OF COMPREHENSIVE INCOME

- ▶ profit and loss account

PROFIT

MEASURING PROFITABILITY

- ▶ gross profit margin:
- ▶ operating profit margin:
- ▶ profit for the year (net profit) margin:

PROFIT

WAYS TO IMPROVE PROFITABILITY

- ▶ raising prices:
- ▶ lowering costs:

PROFIT

DISTINCTION BETWEEN CASH AND PROFIT



PROFIT

CASE STUDY: SALWELL



PROFIT

KEY TERMS

- ▶ amortisation:
- ▶ cost of sales:
- ▶ exceptional costs:
- ▶ gross profit:
- ▶ gross profit margin:
- ▶ operating profit:
- ▶ operating profit margin:
- ▶ profit for the year (net profit) or net profit:
- ▶ profit for the year (net profit) margin or net profit margin:
- ▶ statement of comprehensive income:
- ▶ revenue or turnover: