

ISCTE-IUL Business School

2nd year Management

Management Accounting II

Planning, control and performance

The budgeting process

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Why do we produce budgets?

1. To aid the *planning* of actual operations:

- by forcing managers to consider how conditions might change and what steps should be taken now.
- by encouraging managers to consider problems before they arise.

2. To *co-ordinate* the activities of the organization:

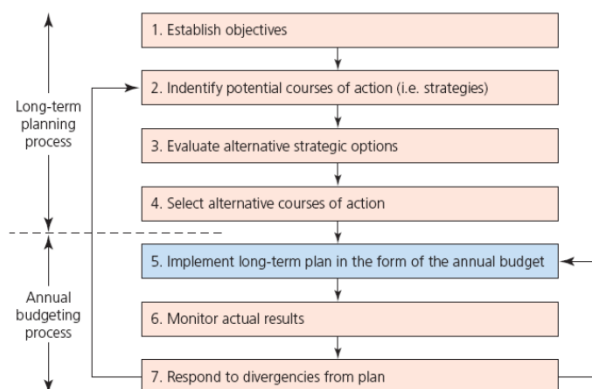
- by compelling managers to examine relationships between their own operation and those of other departments.

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Figure 1 – The role of long and short term planning within the planning, decision-making and control process

1. Identify the objectives of the organization.
2. Identify potential strategies.
3. Evaluate alternative strategic options.
4. Select course of action.
5. Implement the long-term plan in the form of the annual budget.
6. Monitor actual results.
7. Respond to divergencies from plan.



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Why do we produce budgets?

3. To *communicate* plans to various responsibility centre managers:

- everyone in the organization should have a clear understanding of the part they are expected to play in achieving the annual budget.
- by ensuring appropriate individuals are made accountable for implementing the budget.

4. To *motivate* managers to strive to achieve the budget goals:

- by focusing on participation
- by providing a challenge/target.

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Why do we produce budgets?

5. To *control* activities:

- by comparison of actual with budget (attention directing/management by exception).

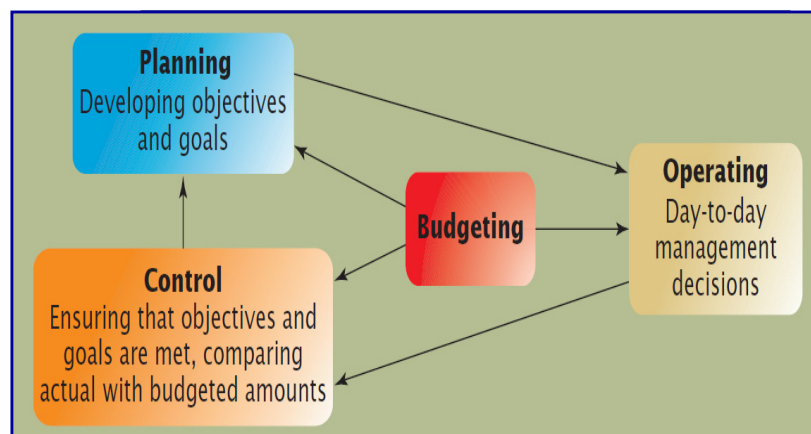
6. To *evaluate* the performance of managers:

- by providing a means of informing managers of how well they are performing in meeting targets they have previously set.

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Figure 2 **Budgeting for Planning, Operating, and Control Activities**



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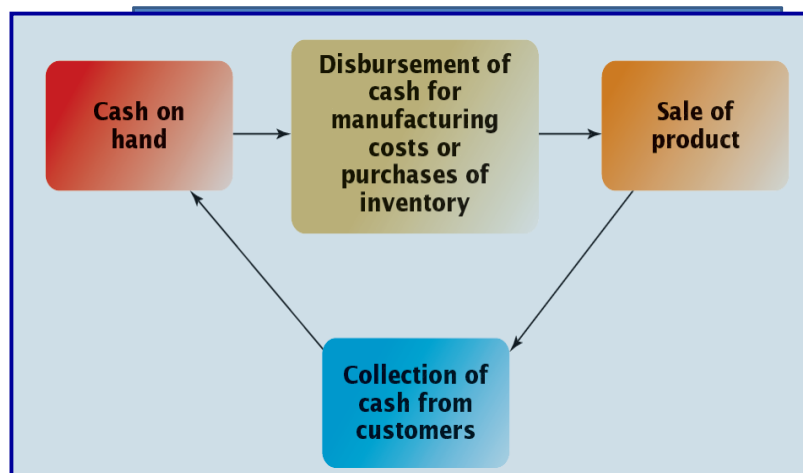
Stages in the budgeting process (operating)

1. Communicate details of budget policy and guidelines to those people responsible for preparing the budget.
2. Determine the factor that restricts output.
3. Preparation of the sales budget.
4. Initial preparation of budgets.
5. Negotiation of budgets with higher management.
6. Co-ordination and review of budgets.
7. Final acceptance of budgets.
8. Ongoing review of the budgets.

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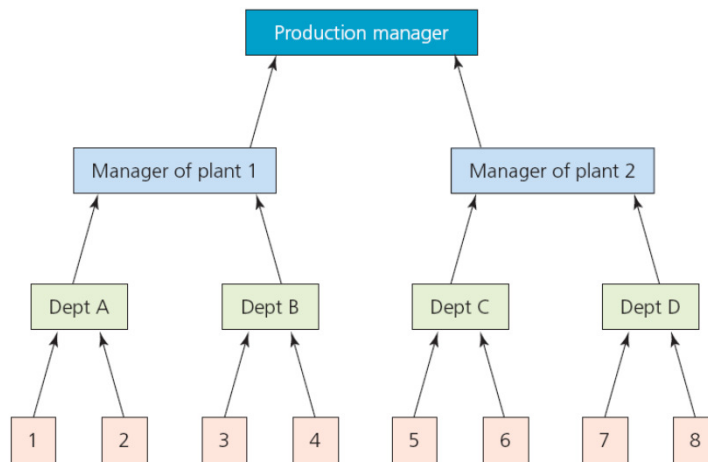
Figure 3 **The Operating Cycle**



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Figure 4 – An illustration of budgets moving up the organization hierarchy



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Activity-based budgeting (ABB)

- Conventional budgeting is inappropriate for those activities where the consumption of resources does not vary proportionately with the volume of the final output of products or services.
- For support activities conventional incremental budgets merely serve as authorization levels for certain levels of spending.
- Incremental budgeting results in the cost of non-unit level activities becoming fixed.
- ABB aims to authorize only the supply of those resources that are needed to perform activities required to meet budgeted production and sales volumes.

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- The ABB process is the reverse of the ABC process:

Budgeted output of cost objects



Determine the necessary activities



Determine the resources required for the budget period

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ABB involves the following stages:

1. Estimate the production and sales volume by individual products and customers.
2. Estimate the demand for organizational activities.
(e.g. process 5,000 customers' orders for the customer order processing activity)
3. Determine the resources that are required to perform organizational activities.
(e.g. 0.5 hours per order = $5,000 \times 0.5 \text{ hours} = 2,500$ labour hours for the customer processing activity must be supplied)

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ABB involves the following stages:

4. Estimate for each resource the quantity that must be supplied to meet the demand.

(e.g. assume a step cost function with each person employed contracted to work 1,500 hours per year so that quantity of resources required = $2,500/1,500 = 1.67$ persons meaning that 2 persons must be employed)

5. Take action to adjust the capacity of resources to match the projected supply.

(e.g. if 3 persons are presently employed on the activity resources must be reduced, or redeployed, by one person)

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• **Periodically actual results should be compared with an adjusted (flexible) budget.**

Example

Budgeted activity for processing orders	= 2,800 orders
Orders processed per person	= 600
Resources required	= 4.67 persons
Resources supplied (practical capacity for 3,000 orders)	= 5 persons
Employment costs (£25,000 per person per year)	= £125,000
Cost driver rate (£125,000/3,000 orders)	= £41.67
Actual orders processed for the period	= 2,500 orders

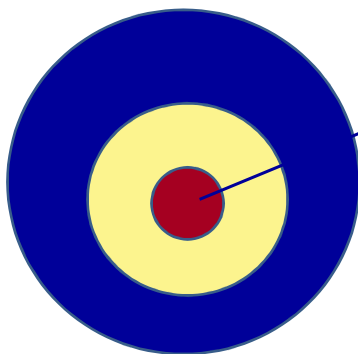
Performance report:

Flexed budget (2,500 × £41.67)	= £104,175
Budgeted unused capacity (3,000 — 2,800) × £41.67	= 8,334
Unplanned unused capacity (2,800 — 2,500) × £41.67	= <u>12,491</u>
	<u>125,000</u>

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Zero-Based Budgeting



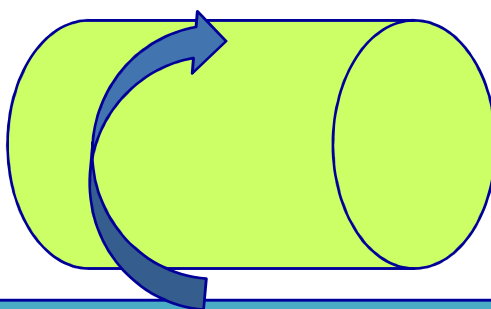
Zero-based budgets require managers to build budgets from the ground up each year rather than just add a percentage increase to last year's numbers.

This way managers must justify all items in the budget, not just changes from last year's budget.

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Rolling Budgets

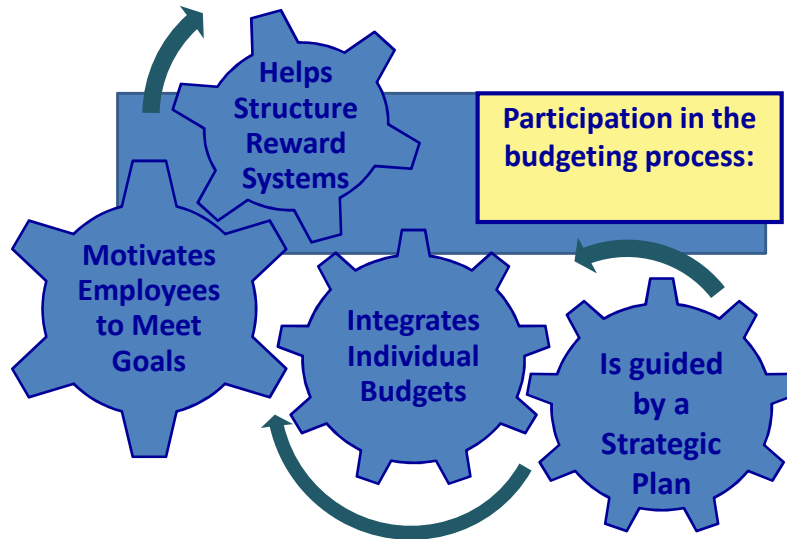


Although we typically think of budgets as being prepared annually, companies frequently use monthly budgets and *rolling* 12-month budgets to provide a mechanism for adjusting items in response to unforeseen circumstances. As the oldest month rolls off the analysis, the newest month is added.

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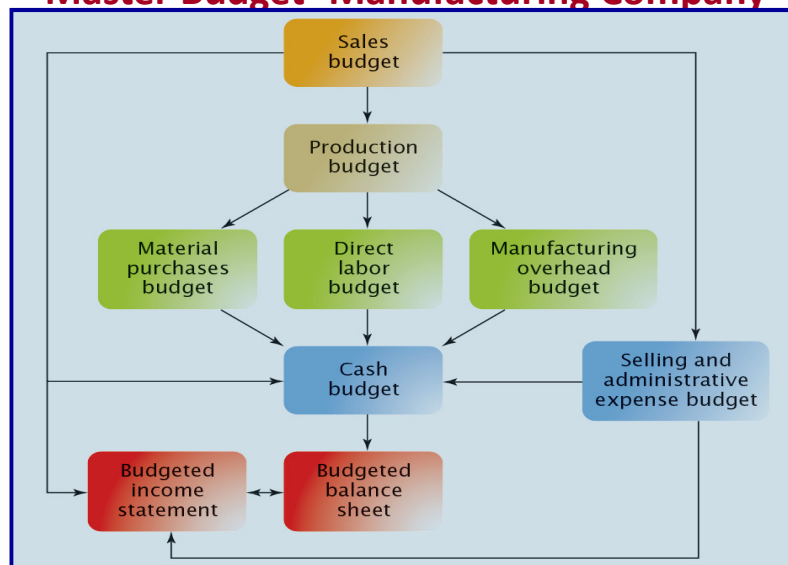
The Focused Process of Budgeting



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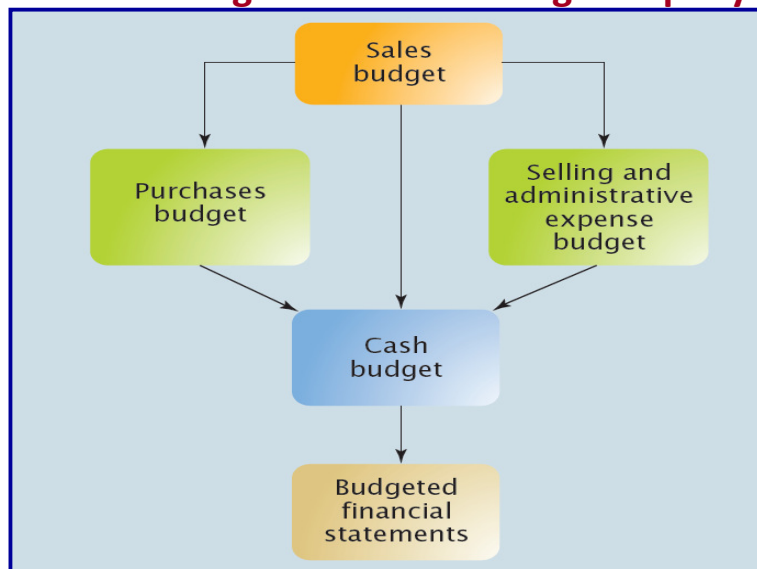
Figure 5
Master Budget- Manufacturing Company



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Figure 6
Master Budget- Merchandising Company



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