Unit 9: Management Accounting: Costing and Budgeting

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UNIT 9: MANAGEMENT ACCOUNTING: COSTING AND BUDGETING

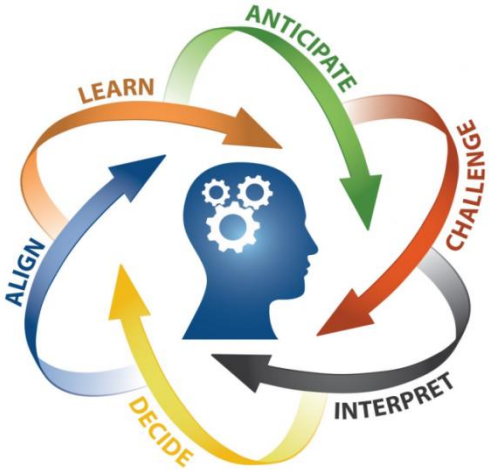
- LEARNING OBJECTIVE3:BE ABLE TO PREPARE FORECASTS AND BUDGETS FOR A BUSINESS

THE BASIC SYLLABUS

- 1. Be able to analyse cost information within a business.
- 2.Be able to propose methods to reduce costs and enhance value within a business.
- 3. Be able to prepare forecasts and budgets for a business.
- 4. Be able to monitor performance against budgets within a business.

LEARINGING OUTCOMES

- Be able to prepare forecasts and budgets for a business



- At the end of the class the students should be able to:
- 3.2 Select appropriate budgeting methods for the organization and its needs.

OVERVIEW

- The budget preparation begins three to six months before the financial year and follows a carefully structured process. 'Ownership' of the budget by responsible managers was found to be important in companies. It was generally recognized that budgeting was time consuming and expensive and two companies had taken action to reduce budget preparation time. The sometimes longwinded nature of the budgeting process did not automatically lead to dissatisfaction, although the interventions of senior managers were criticised in two companies.

LIMITING OR KEY FACTORS

- The principal budget factor is the factor that limits the activities of functional budgets of the organisation.
- The early identification of this factor is important in the budgetary planning process because it indicates which budget should be prepared first.
- In general sales volume is the principal budget factor. So sales budget must be prepared first, based on the available sales forecasts. All other budgets should then be linked to this.

LIMITING OR KEY FACTORS

- Alternatively, machine capacity may be limited for the forthcoming period and therefore machine capacity is the principal budget factor. In this case the production budget must be prepared first and all other budgets follows it.
- Failure to identify the principal budget factor at an early stage could lead to delays later on when managers realize that the targets they have been working with are not feasible.

MASTER BUDGET

- A master budget is a set of interconnected budgets of sales, production costs, purchases, incomes, etc. and it also includes pro forma financial statements. A budget is a plan of future financial transactions. A master budget serves as planning and control tool to the management since they can plan the business activities during the period on the basis of master budget. At the end of each period, actual results can be compared with the master budget and necessary control actions can be taken.

MASTER BUDGET

- The components of master budget are interconnected, which means that numbers from one component budget flow to another one. For example sales budget numbers are used in schedule of cash receipts from customers and unless the sales budget is prepared we are unable to prepare schedule of receipts from customers because of lack of information. This means that components of master budget must be prepared in a specific order. We have ordered the above list in such a way that the necessary information needed by any component budget is provided by a preceding component.

SUBSIDIARY AND FUNCTIONAL BUDGETS

- Functional Budget: The functional budget is one which relates to any of the functions of an
- organization. The number of functional budgets depend upon the size and nature of business. The
- following are the commonly used:
- (1) Sales Budget
- (2) Purchase Budget
- (3) Production Budget
- (4) Selling and Distribution Cost Budget
- (5) Labour Cost Budget
- (6) Cash Budget
- (7) Capital Expenditure Budget

CASH BUDGETS

- Cash is an essential resource. Without an adequate supply of cash to meet obligations as they come due, a business will quickly crash. Even the most successful businesses can get caught by cash crunches attributable to delays in collecting receivables, capital expenditures, and so on.

CASH BUDGETS

- These types of cash crises can usually be avoided. The cash budget provides the necessary tool to anticipate cash receipts and disbursements, along with planned borrowings and repayments.

PREPARATION OF SALES BUDGET

- The budgeting process usually begins with a sales budget. The sales budget reflects forecasted sales volume and is influenced by previous sales patterns, current and expected economic conditions, activities of competitors, and so forth. The sales budget is complemented by an analysis of the resulting expected cash collections.

PREPARATION OF SALES BUDGET

- Sales often occur on account, so there can be a delay between the time of a sale and the actual conversion of the transaction to cash. For the budget to be useful, careful consideration must also be given to the timing and pattern of cash collections.

PREPARATION OF DEBTORS BUDGET

- The debtor's budget shows the balance owed to the firm by the debtors of the firm. This will be determined by:
- Level of credit sales
- Length of credit period offered.
- Once, the sales budget has been produced, if the firm's credit policy has been decided, then the debtors budget can be produced.

CREDITORS BUDGET

- Once the level of purchases has been decided (which will comes from the production budget, which, in turn, comes from the sales budget). The firm will then be able to draw up the creditors budget. This budget outlines how much at any time is owed to the suppliers of the firm

PRODUCTION COSTS

- A cost incurred by a business when manufacturing a good or producing a service. Production costs combine raw material and labor. To figure out the cost of production per unit, the cost of production is divided by the number of units produced. A company that knows how much it will cost to produce an item, or produce a service, will have a clearer picture of how to better price the item or service and what will be the total cost to the company.

RAW MATERIALS BUDGETS

- There are two methods of developing the raw materials inventory budget. First, budget each important inventory item separately based on the production plan. Second, budget materials as a whole or classes of material, based on selected production factors. Practically all companies must use both approaches to some extent, although one or the other predominates. The former method is always preferable to the extent that it is practicable, because it allows quantities to be budgeted more precisely.

RAW MATERIALS BUDGETS

- The following steps should be taken in budgeting the major individual items of raw materials:
- Determine the physical units of material required for each item of goods to be produced during the budget period.
- Accumulate these into total physical units of each material item required for the entire production plan.
- Determine for each item of material the quantity that should be on hand periodically to fulfill the production plan with a reasonable margin of safety.
- Deduct material inventories that are expected to be on hand at the beginning of the budget period to ascertain the total quantities to be purchased.

RAW MATERIALS BUDGETS

- Develop a purchasing plan that will ensure that the quantities will be on hand at the time they are needed. The purchasing plan must consider such factors as economically sized orders, economy of transportation, and margin of safety against delays.
- Test the resulting budgeted inventories by standard turnover rates.
- Translate the inventory and purchasing requirements into dollars by applying the expected prices of materials to budgeted quantities.

FINISHED GOODS BUDGET

- The primary purpose of this budget is to provide the amount of the inventory asset that appears in the budgeted balance sheet, which is then used to determine the amount of cash needed to invest in assets. If you do not intend to create a budgeted balance sheet, there is no need to create an ending finished goods inventory budget. When a company needs to closely monitor its cash balances on an ongoing basis, the ending finished goods inventory budget should not only be created, but also updated on a regular basis.

FINISHED GOODS BUDGET

- The ending finished goods inventory budget contains an itemization of the three main costs that are required to be included in the inventory asset under both generally accepted accounting principles and international financial reporting standards. These costs and their derivation are:

- Direct materials. The cost of materials per unit (as listed in the direct materials budget), multiplied by the number of ending units in inventory (as listed in the production budget).

FINISHED GOODS BUDGET

- Direct labor. The direct labor cost per unit (as listed in the direct labor budget), multiplied by the number of ending units in inventory (as listed in the production budget).
- Overhead allocation. The amount of overhead cost per unit (as listed in the manufacturing overhead budget), multiplied by the number of ending units in inventory (as listed in the production budget).

FINISHED GOODS BUDGET

- If there are many types of products expected to be in ending inventory, it may be too difficult to calculate this budget on an item-by-item basis. If so, an alternative is to create an approximate cost per unit based on general classifications of inventory types; this derivation is usually based on historical costs, modified for costs expected to be incurred during the budget period.

REVIEW QUESTIONS

- Wollongong wishes to calculate an operating budget for the forthcoming period.
- Information regarding products, costs and sales levels is as follows:

Product	A	B
Materials required		
X (kg)	2	3
Y (litres)	1	4
Sales level (units)	2000	1500
Opening stocks (units)	100	200

- Closing stock of materials and finished goods will be sufficient to meet 10% of
- demand. Opening stocks of material X was 300 kg and for material Y was 1000
- litres. Material prices are £10 per kg for material X and £7 per litre for material Y.

- Required:
- Produce the following budgets:
- (a) materials usage (kg and litres);
- (b) materials purchases (kg, litres and £);
- Source: Drury. C. (2015) Cost and Management Accounting

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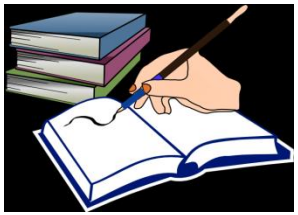

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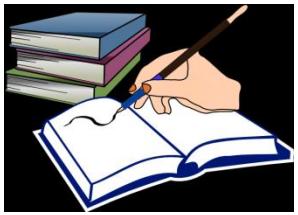

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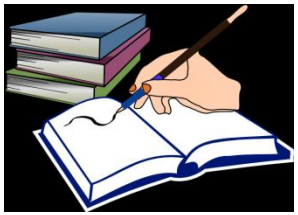

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