UNIT 13: MANAGING FINANCIAL PRINCIPLES AND TECHNIQUES

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- LO 2 : BE ABLE TO APPLY FORECASTING TECHNIQUES TO OBTAIN INFORMATION FOR DECISION MAKING

THE BASIC SYLLABUS

- 1. Be able to apply cost concepts to the decision making process.

2. Be able to apply forecasting techniques to obtain information for decision making.

3.Be able to participate in the budgetary process of an organisation.

4. Be able to recommend cost reduction and management processes for an organisation.

5.Be able to use financial appraisal techniques to make strategic investment decisions for an organisation.

6.Be able to interpret financial statements for planning and decision making.

LEARNING OBJECTIVES

- Be able to participate in the budgetary process of an organisation

- At the end of the class the students should be able to:-
- Evaluate budgetary monitoring processes in an organisation.

OVERVIEW

- A budget is a set of interlinked plans that quantitatively describe an entity's projected future operations. A budget is used as a yardstick against which to measure actual operating results, for the allocation of funding, and as a plan for future operations.
- A budget is subject to a number of problems, such as the "use it or lose it" mentality, whereby managers spend all funds allocated to their departments on the grounds that those expenditures form the basis for their budgets in the following year; not spending all allocated funds will therefore mean that the budget will likely be reduced in the following year.

TYPES

- There are many types of budgets. They may be classified into several basic types. Most organizations develop and make use of three different types of budgets: operating budgets, capital expenditures budgets, and financial budgets.

TYPES

- An operating budget is a statement that presents the financial plan for each responsibility centre during the budget period and reflects operating activities involving revenues and expenses. The most common types of operating budgets are expense, revenue, and profit budgets.

TYPES

- Expense Budget
- An expense budget is an operating budget that documents expected expenses during the budget period. Three different kinds of expenses normally are evaluated in the expense budget - fixed, variable and discretionary (Discretionary expenses - costs that depend on managerial judgment because they cannot be determined with certainty, for example: legal fees, accounting fees and R&D expenses).

TYPES

- Revenue Budget
- A revenue budget identifies the revenues required by the organization. It is a budget that projects future sales.

TYPES

- Profit Budget
- A profit budget combines both expense and revenue budgets into one statement to show gross and net profits. Profit budgets are used to make final resource allocation, check on the adequacy of expense budgets relative to anticipated revenues, control activities across units, and assign responsibility to managers for their shares of the organization's financial performance.

TYPES

- Financial Budgets outline how an organization is going to acquire its cash and how it intends to use the cash. Three important financial budgets are the cash budget, capital expenditure budget and the balance sheet budget.
- Cash budget
- Cash budgets are forecasts of how much cash the organization has on hand and how much it will need to meet expenses. The cash budget helps managers determine whether they will have adequate amounts of cash to handle required disbursements when necessary, when there will be excess cash that needs to be invested, and when cash flows deviate from budgeted amounts.

TYPES

- **Capital Expenditure Budget**
- Capital Expenditure Budgets. Investment in property, buildings and major equipment are called capital expenditure. Such capital expenditure budgets allow management to forecast capital requirements, to on top of important capital projects, and to ensure the adequate cash is available to meet these expenditures as they come due.

TYPES

- **The balance sheet budget**
- The balance sheet budget plans the amount of assets and liabilities for the end of the time period under considerations. A balance sheet budget is also known as a pro forma (projected) balance sheet. Analysis of the balance sheet budget may suggest problems or opportunities that will require managers to alter some of the other budgets.

FLEXIBLE AND FIXED BUDGETS

- The flexible budget is a performance evaluation tool. It cannot be prepared before the end of the period. A flexible budget adjusts the static budget for the actual level of output. The flexible budget asks the question: “If I had known at the beginning of the period what my output volume (units produced or units sold) would be, what would my budget have looked like?” The motivation for the flexible budget is to compare apples to apples. If the factory actually produced 10,000 units, then management should compare actual factory costs for 10,000 units to what the factory should have spent to make 10,000 units, not to what the factory should have spent to make 9,000 units or 11,000 units or any other production level.
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- The flexible budget variance is the difference between any line-item in the flexible budget and the corresponding line-item from the statement of actual results.
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- The following steps are used to prepare a flexible budget:
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- 1. Determine the budgeted variable cost per unit of output. Also determine the budgeted sales price per unit of output, if the entity to which the budget applies generates revenue (e.g., the retailer or the hospital).
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- 2. Determine the budgeted level of fixed costs.
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Flexible and Fixed Budgets

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- 3. Determine the actual volume of output achieved (e.g., units produced for a factory, units sold for a retailer, patient days for a hospital).
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- 4. Build the flexible budget based on the budgeted cost information from steps 1 and 2, and the actual volume of output from step 3.
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- Flexible budgets are prepared at the end of the period, when actual output is known. However, the same steps described above for creating the flexible budget can be used prior to the start of the period to anticipate costs and revenues for any projected level of output, where the projected level of output is incorporated at step 3. If these steps are applied to various anticipated levels of output, the analysis is called pro forma analysis. Pro forma analysis is useful for planning purposes. For example, if next year's sales are double this year's sales, what will be the company's cash, materials, and labor requirements in order to meet production needs?

FLEXIBLE AND FIXED BUDGETS

- A fixed budget is one that is prepared keeping in mind a single level of output. It is defined like a budget which is created to remain the same irrespective of the level of activity gained. If actual output varies from budgeted level of output, variances will come up. Fixed budget is prepared on the assumption that sales and output could be estimated with a good degree of accuracy. This implies that in those situations in which output and sales cannot be correctly estimated, fixed budget does not suit.

ZERO BASED BUDGETING

- A zero-base budget requires managers to justify all of their budgeted expenditures, rather than the more common approach of only requiring justification for incremental changes to the budget or the actual results from the preceding year. Thus, a manager is theoretically assumed to have an expenditure base line of zero (hence the name of the budgeting method).
- In reality, a manager is assumed to have a minimum amount of funding for basic departmental operations, above which additional funding must be justified. The intent of the process is to continually refocus funding on key business objectives, and terminate or scale back any activities no longer related to those objectives.

ZERO BASED BUDGETING

- The basic process flow under zero-base budgeting is:

- -Identify business objectives
- -Create and evaluate alternative methods for accomplishing each objective.
- -Evaluate alternative funding levels, depending on planned performance levels
- -Set priorities
- The concept of paring back expenses in layers can also be used in reverse, where you delineate the specific costs and capital investment that will be incurred if you add an additional service or function. Thus, management can make discrete determinations of the exact combination of incremental cost and service for their business. This process will typically result in at least a minimum service level, which establishes a cost baseline below which it is impossible for a business to go, along with various gradations of service above the minimum

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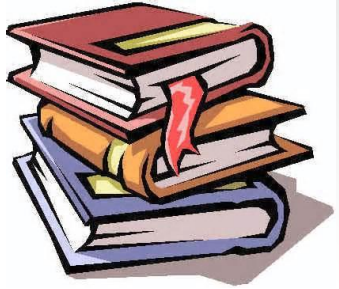

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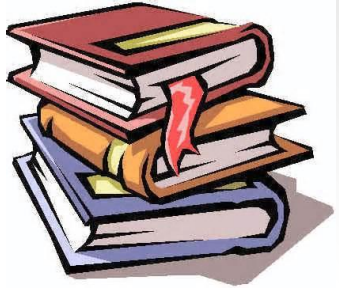

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