Management Accounting: Costing and Budgeting

Level 5: Unit 9

Lecturer: Matthew Smith-Barrett

Unit Content: (Syllabus)

Level 5: Unit 9

On successful completion of this unit a leaner will:

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

Learning Outcome 3:

Level 5: Unit 9

Upon completion of this Learning Outcome, students should:

- Be able to prepare forecasts and budgets for a business

To realize the above objective the leaner should be able to:

3.1 explain the purpose and nature of the budgeting process

3.2 select appropriate budgeting methods for the organization and its needs

3.3 prepare budgets according to the chosen budgeting method

3.4 prepare a cash budget

Week 10 - Assessment Criteria 3.3:

Level 5: Unit 9

Assessment Criteria 3.3:

Upon completion of this lesson, students will be able to:

Prepare budgets according to the chosen budgeting method

Week 10 – Prepare budgets according to the chosen budgeting method

Level 5: Unit 9

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Recap: Select appropriate budgeting methods or the organization and its needs

L.O. 3:
A.C. 3.2

- Budget preparation?
- Stages in the Preparation of Budgets
- Limiting or Key factors
- Master Budgets
- Cash Budgets and their preparation
- Preparing other budgets
- Sales Budget

Methods of Budget preparation

L.O. 3: A.C. 3.3

There are several methods of Budget Preparation. Namely:

- Incremental Budgeting
- Zero-based Budgeting
- Fixed and Flexible Budgeting; and
- Activity Based Budgeting (similar to A.B.C.)

Incremental Budgeting

L.O. 3: A.C. 3.3

- Budget setting is often done on the basis of what happened last year, with some adjustmentfor any changes in factors that are expected to affect the forthcoming budget period (for example, inflation).
- This approach is known as **incremental budgeting** and is often used for ‘discretionary’ budgets, such as research and development and staff training

Zero based Budgeting

L.O. 3: A.C. 3.3

Zero-base budgeting (ZBB) rests on the philosophy that all spending needs to be justified. Thus, when establishing, say, the training budget each year, it is not automatically accepted that training courses should be financed in the future simply because they were undertaken this year.

The training budget will start from a zero base (that is, no resources at all) and will only be increased above zero if a good case can be made for the scarce resources of the business to be allocated to this form of activity. Top management will need to be convinced that the proposed activities represent 'value for money'.

Fixed and Flexible Budgeting

L.O. 3: A.C. 3.3

- A **Fixed budget** is a budget that does not change or flex when sales or some other activity increases or decreases. Also referred to as a static budget.
- A Flexible Budget is a budget that adjusts or flexes for changes in the volume of activity. The flexible budget is said to be more sophisticated and useful than a static Budget, which remains at one amount regardless of the volume of activity.

Fixed Budgeting Illustration

L.O. 3: A.C. 3.3

- Assume that a company pays commission on its sales at a rate of 5%. If the company prepares a fixed budget and it is projecting sales of $1 million, its budget for sales commissions will be fixed at $50,000. If the actual sales end up being only $900,000 the budget for commissions will remain unchanged at the fixed amount of $50,000.

Flexible Budgeting Illustration

L.O. 3: A.C. 3.3

- Assume that a manufacturer determines that its cost of electricity and supplies for the factory are approximately $10 per machine hour (MH). It also knows that the factory supervision, depreciation, and other fixed costs are approximately $40,000 per month. Typically, the production equipment operates between 4,000 and 7,000 hours per month. Based on this information, the flexible budget for each month would be $40,000 + $10 per MH.

Activity Based Budgeting

L.O. 3: A.C. 3.3

- **Activity-based budgeting (ABB)** extends the principles of activity-based costing (ABC).
- Under a system of ABB, the budgeted sales of products or services are determined and the activities necessary to achieve the budgeted sales are then identified. Budgets for each of the various activities are prepared by multiplying the budgeted usage of the cost driver for a particular activity (as determined by the sales budget) by the budgeted rate for the relevant cost driver.

Conclusion:

L.O. 3: A.C. 3.3

In recent years, a few businesses have abandoned budgeting, although they still recognise the need for forward planning. No one seriously doubts that there must be appropriate systems in place to steer a business towards its objectives. It is claimed, however, that the systems adopted should reflect a broader, more integrated approach to planning. The new systems that have been implemented are often based around a ‘leaner’ financial planning process that is more closely linked to other measurement and reward systems.

Reference List

L.O. 3: A.C. 3.3

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- Cliche, P. (2012). "Budget," in L. Côté and J.-F. Savard (eds.), Encyclopedic Dictionary of Public Administration, http://www.dictionnaire.enap.ca/Dictionnaire/en/home.aspx