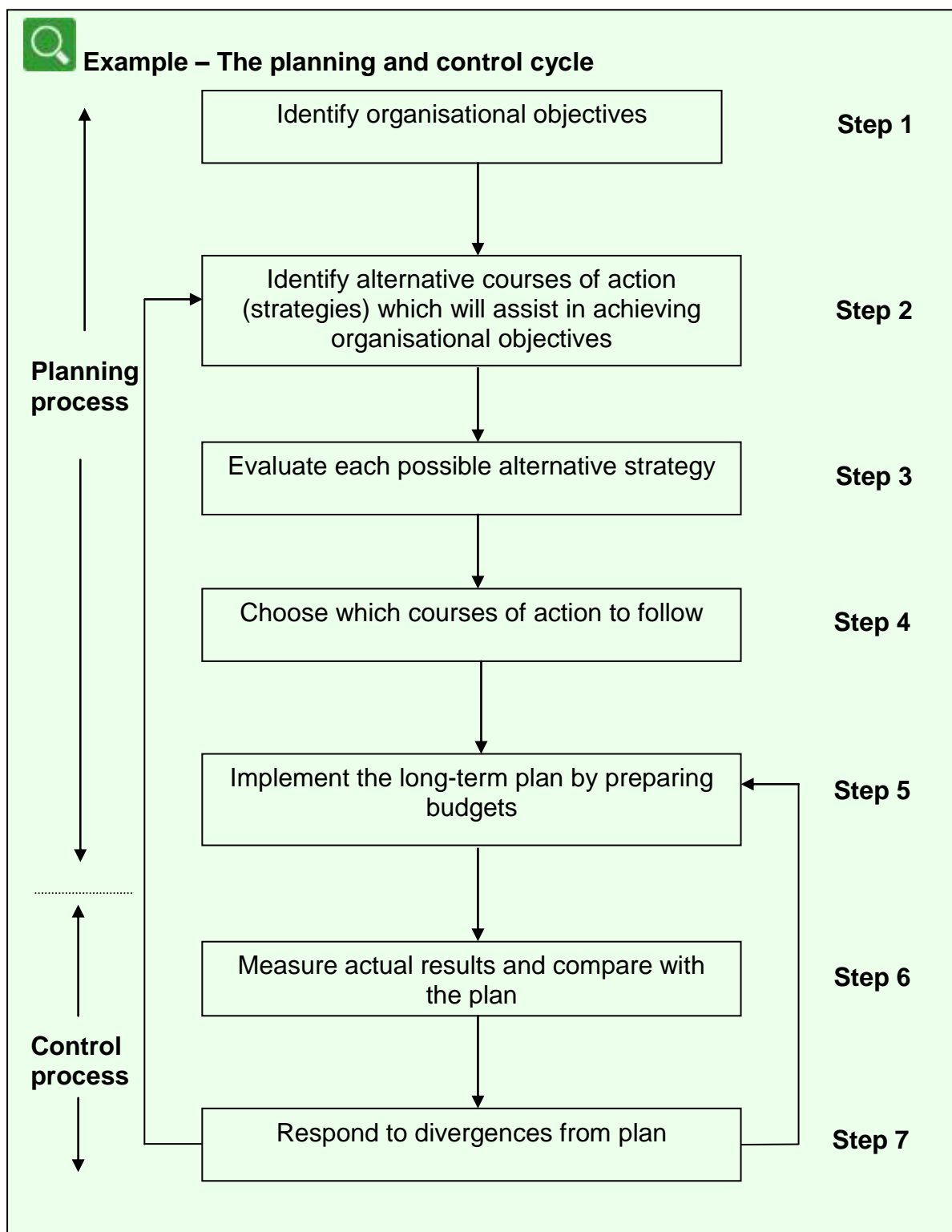




Home Learning
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**AAT LEVEL 4 DIPLOMA FOR ACCOUNTING
TECHNICIANS (QCF)**

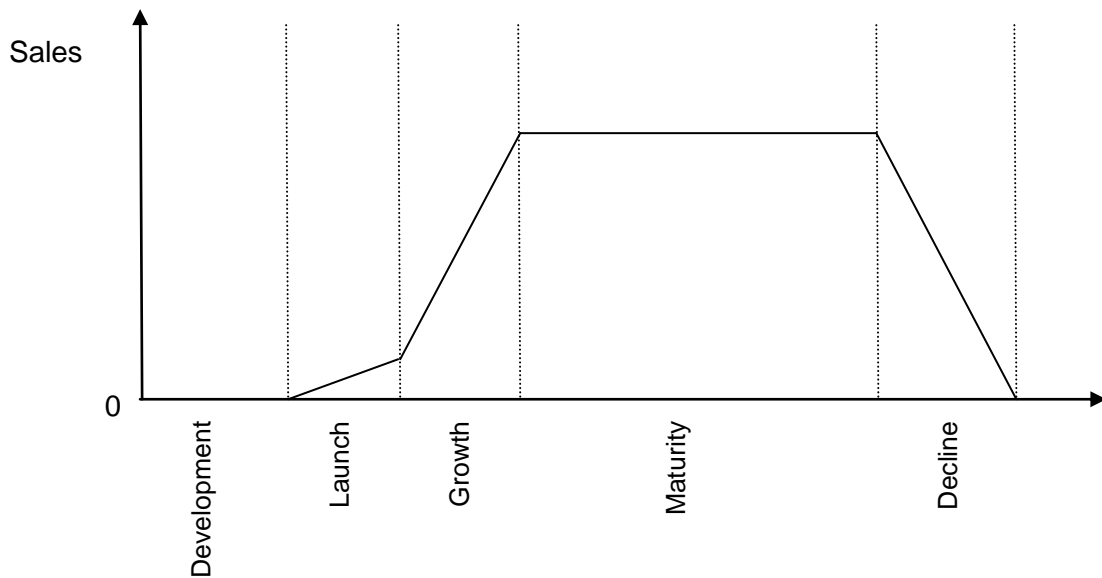
BUDGETING



Step 1 – Identify organisational objectives

The starting point for creating a plan is to decide what the organisation wants to achieve in the long-term. These are known as objectives. Each organisation will have its own objectives depending on its nature. Examples of objectives include:

Graphical diagram of product life cycle



It is important therefore, whenever forecasting, to take account of where the product is in its life cycle since this will affect the number of sales to be made in the future.

Life cycle budgeting is where the costs and revenues for a product or service are forecast for the whole of its life cycle. The budget covers all stages of the products life cycle from development through to cessation. The budgeted revenues and costs will be adjusted to reflect changes as the cycle progresses. For example, the selling price during maturity is likely to be higher than during decline, and demand volumes will change over time.

Other considerations

There are other considerations to be made when forecasting and these surround the marketplace for the product.

An analysis of the marketplace can be made using a PEST analysis. The PEST analysis looks at four different factors that could affect demand for the product: political, economic, social and technological.

Political factors

Governmental policies can have a wide reaching effect on organisations because they have control over issues such as imports and exports, exchange rate mechanisms, trade tariffs, minimum wage rates and taxation.

Economic factors

When the economy is booming consumers will be confident and are more inclined to spend money. But during times of recession and unemployment there will be less money circulating in the economy and therefore sales of many products will decline as consumers spend only on essentials. The economy is generally cyclical in nature but governments try and restrict this cyclical nature by trying to achieve periods of sustained growth.



Example – Materials usage budget

Each Wingett requires 2 kilos (kgs) of material Win and 3 kilos of material Gett.

Required

Prepare the materials usage budget for Hansome Ltd for January, February and March.

Solution

As there are two materials used in the process a materials usage budget will need to be prepared for each material.

	January	February	March
	Kgs	Kgs	Kgs
Material Win – 2kg per unit	6,060 (3,030 x 2kg)	6,666 (3,333 x 2kg)	7,332 (3,666 x 2kg)
Material Gett – 3kg per unit	9,090 (3,030 x 3kg)	9,999 (3,333 x 3kg)	10,998 (3,666 x 3kg)

Materials purchases budget

Once the materials usage budget has been prepared then the amount of material that actually needs to be purchased can be calculated. Once again any changes in opening and closing inventory levels of raw materials will need to be incorporated into this budget.

The material to be purchased is calculated as:

	Quantity of material to be used (per material usage budget)
Less:	Opening inventory of raw materials
Plus:	Closing inventory of raw materials
Equals:	Budgeted material purchases

This budget is expressed in both units (e.g. kgs or litres) and in value. The value is calculated by multiplying the quantity of material required by the expected cost per unit of raw material.



Example – Flexing semi-variable costs

Assume that the costs for production overheads are semi-variable in the earlier example. The fixed element is £6,000 within an activity range of 1,500 – 2,500 units.

It is necessary to calculate the variable element so that it can be flexed.

$$\begin{aligned}
 & (\text{£}12,000 - \text{£}6,000) \\
 & = \text{£}6,000 \text{ variable element} \div 2,000 \text{ units (original budgeted activity)} \\
 & = \text{£}3 \text{ per unit} \times 2,400 \text{ units (actual activity)} \\
 & = \text{£}7,200 + \text{£}6,000 \text{ (fixed element)} = \text{£}13,200 \text{ flexed budgeted cost}
 \end{aligned}$$

The key point to remember is that once the variable element has been flexed then the fixed element must be added on to arrive at total flexed cost. If the variable element had been supplied instead of the fixed element then the calculation to find the fixed element would be:

$$\text{£}12,000 - (2,000 \times \text{£}3) = \text{£}6,000 \text{ fixed element}$$

Once all of the revenue and cost figures have been flexed then a flexed budget can be prepared and compared to the actual figures to calculate any variances.



Example – Flexed budget variances

Using the figures and calculations from the earlier example, a revised variance statement can be prepared that compares the flexed budget with the actual figures. The general expenses are assumed to be a fixed cost.

Units	2,000 Original Budget £	2,400 Flexed Budget £	2,400 Actual £	Variance £	
Sales	80,000	96,000	91,200	(4,800)	A
Less:					
Direct materials	(24,000)	(28,800)	(27,600)	1,200	F
Direct labour	(6,000)	(7,200)	(7,680)	(480)	A
Production overheads	(12,000)	(13,200)	(14,640)	(1,440)	A
Gross profit	<u>38,000</u>	<u>46,800</u>	<u>41,280</u>	<u>(5,520)</u>	A
General expenses	<u>(18,000)</u>	<u>(18,000)</u>	<u>(16,400)</u>	<u>1,600</u>	F
Operating profit	<u>20,000</u>	<u>28,800</u>	<u>24,880</u>	<u>(3,920)</u>	A



SELF-TEST QUESTIONS

Now attempt these questions on Lesson 5 and check your answers with the model answers on the VLC.

[Note: The self-test questions for Lesson 6 follow on from the self-test questions here and therefore students should attempt these questions and keep their answers to refer to when undertaking the questions for Lesson 6]

QUESTION 5.1

The following is a copy of the original budget and actual performance of a company for the last financial year.

Draft operating statement

Sales volume (units)	Original budget 100,000		Actual budget 120,000	
	£000	£000	£000	£000
Sales		30,000		33,000
Material 1	5,000		6,264	
Material 2	1,980		3,114	
Material 3	2,730		3,528	
Labour	5,400		5,960	
Power	2,680		3,100	
Maintenance	1,490		1,974	
Rent and rates	1,880		1,890	
Administrative expenses	1,700		1,600	
Total expenses		<u>22,860</u>		<u>27,430</u>
Operating profit		<u>7,140</u>		<u>5,570</u>

Assumptions made when preparing the original budget:

- All material and labour costs are variable
- Power is a semi-variable cost. The variable element is £18 per unit produced.
- Maintenance is a stepped variable cost. For every £298,000 spent on maintenance the company produces 20,000 units.
- Rent and rates and administrative expenses are fixed costs.
- There was no opening or closing inventory.
- There were no purchases or sales of fixed assets during the year.

Required

Part a

Calculate the following budgeted prices and costs:

(i) Selling price per unit

(ii) Cost of material per unit for each of the three materials

Control action

Once management are aware of the results for a period and the cause of any variances, they can use this information to make decisions on what action, if any, should be taken. The types of action that might be taken will depend on the causes of the variances identified and whether the cause is controllable. It might also depend upon whether the variance is a short-term variance or a long-term variance. Short-term variances might be expected to reverse and therefore even out however long-term variances might require control action.

Possible control action could include:

- Reviewing the construction of the budgets to ensure that the method selected is appropriate and enables accurate and up to date information to be used. The budgets should take account of inflation, the effects of learning curves on operations and technological changes.
- Ensure that the procedures for collecting the actual information are consistent and result in accurate results for comparison with budget
- Take steps to control inefficiencies in working practices. This could be through better training of staff, increased supervision to reduce idle time or material wastage.



Feedforward is where the information collected from one period is used to inform the actions required to improve future activities, procedures and budgeting.

Feedback, control action and feedforward are part of the planning and control cycle that was explained in lesson 2. This continuous cycle of comparison and action can be used to improve organisational operations and meet organisational targets.

Presenting reports

The type of report format used will depend upon the requirements of management. When presenting a variance report it is important to show the flexed budget figures, the actual results and the resulting variances, identified as either adverse or favourable. Where the budget has been flexed to actual activity, it may be useful to also include the original fixed budget figures.

If required, the variances that fall outside the control limits can be highlighted so that they can be immediately identified by management.

If the report is to identify possible consequences for the organisation arising from these variances and make recommendations on control action that could be taken, then it is important that the variances have been discussed with the budget holders and other managers. This will ensure that those involved in the day-to-day operations of the organisation have an opportunity to influence future activities.