<u>**Budgets**</u>

<u>Definition</u>

A budget is a statement of <u>*planned*</u> future results which are expected to follow from the actions taken by management. A budget expresses management's **plans for the future** of the business in money terms.
A budget is different to a forecast – a *forecast* is an estimate of the likely position of a business in future, based on past or present conditions.

<u>Important terms</u>

1. Top Down Budgeting – prepared by upper management for lower management
2. Bottom Up Budgeting – prepared by lower management for upper management
3. Principal (Limiting) budget factor – anything which restricts the budget level of activity for example *limited demand for the product; shortages of materials; shortage of labour)*
4. Management by exception – management only focus on those items which deviate from the budget (all other factors do not need the time of management)
5. Zero based budgeting – each item of expenditure must show justify the benefit gained by it before it will be included in the budget. This is different to taking last years budget and updating it for inflation.
6. **FUNCTIONAL (OPERATING) BUDGETS –** budgets prepared for each department or function within the business eg Sales, Production, Purchasing etc.
7. **MASTER BUDGET –** is a budgeted Profit and Loss Account and Balance Sheet, prepared from the Operating Budgets.

<u>Factors to consider when preparing budgets</u>

1. the long-term objectives of the business
2. the Principal Budget (or Limiting Factors)
3. Internal factors eg managers preparing easy budgets to meet; staff training and moral, finance available)
4. External factors eg economic; political; environmental
5. Budgets must be flexible

<u>Uses and benefits of budgets</u>

1. formalize management's plans
2. ensures that all departments of the business are co-ordinated
3. future shortages of materials and/or cash can be indicated giving time to prepare plans for these shortages
4. commitment by management in all areas of the business is improved
5. ensures responsibility by the managers who prepared the budgets
6. improves control of business activities

Preparing Functional (Operating) Budgets

These are budgets set for each department or function within the business. All these budgets will be governed by the Principal Budget Factor.

Types of Functional Budgets:
Sales Budget
Production Budget
Purchasing Budget
Expenditure Budget
Cash Budget

Operating Budgets must match each other.

- The Sales Budget is normally set **first** as all the other budgets are dependant on the volume of products the business will sell.

- The production Budget is then set as the volume of goods produced is determined by the volumes set in the Sales Budget. *NOTE – this budget is only set for manufacturing type businesses.*

- The Purchasing Budget is then prepared as it is dependant on the volume of goods to be produced in the Production Budget (for manufacturing type businesses) or from the volume of goods to be sold from the Sales Budget (for trader type businesses).

- The Expenditure Budget is then prepared as it includes the amount of purchases from the Purchasing Budget as well as all other expenses.

- The Cash Budget is then prepared from the Sales and Expenses Budgets.

Preparing the Master Budget

This is a budgeted Profit and Loss Account and Balance Sheet (many examiners call it a *forecasted Profit and Loss Account and Balance Sheet*)

Most Exam questions require a Cash Budget to be prepared together with the Master Budget.
REMEMBER – a Cash Budget includes *all cash receipts and payments* irrespective of which year they are applicable to and does not include non-cash items such as depreciation.
A Master Budget is prepared on the accrual basis (accruals and prepayments) and includes non-cash items such as depreciation and profit/loss on disposal of assets.