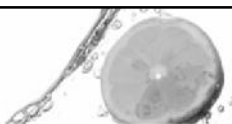


MANAGEMENT AND  
COST ACCOUNTING  
7TH EDITION



## The budgeting process

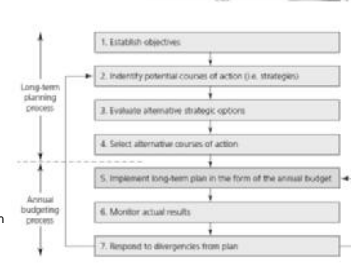
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Why do we produce budgets?

- To *communicate* plans to various responsibility centre managers:
  - everyone in the organization should have a clear understanding of the part they are expected to play in achieving the annual budget.
  - by ensuring appropriate individuals are made accountable for implementing the budget.
- To *motivate* managers to strive to achieve the budget goals:
  - by focusing on participation
  - by providing a challenge/target.

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FIGURE 15.1  
The role of long- and short-term planning within the planning, decision-making and control process



1. Identify the objectives of the organization.  
2. Identify potential strategies.  
3. Evaluate alternative strategic options.  
4. Select course of action.  
5. Implement the long-term plan in the form of the annual budget.  
6. Monitor actual results.  
7. Respond to divergencies from plan.

Long-term planning process  
Annual budgeting process

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- To *control* activities:
  - by comparison of actual with budget (attention directing/management by exception).
- To *evaluate* the performance of managers:
  - by providing a means of informing managers of how well they are performing in meeting targets they have previously set.

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Why do we produce budgets?

- To aid the *planning* of actual operations:
  - by forcing managers to consider how conditions might change and what steps should be taken now.
  - by encouraging managers to consider problems before they arise.
- To *co-ordinate* the activities of the organization:
  - by compelling managers to examine relationships between their own operation and those of other departments.

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Stages in the budgeting process

- Communicate details of budget policy and guidelines to those people responsible for preparing the budget.
- Determine the factor that restricts output.
- Preparation of the sales budget.
- Initial preparation of budgets.
- Negotiation of budgets with higher management.
- Co-ordination and review of budgets.
- Final acceptance of budgets.
- Ongoing review of the budgets.

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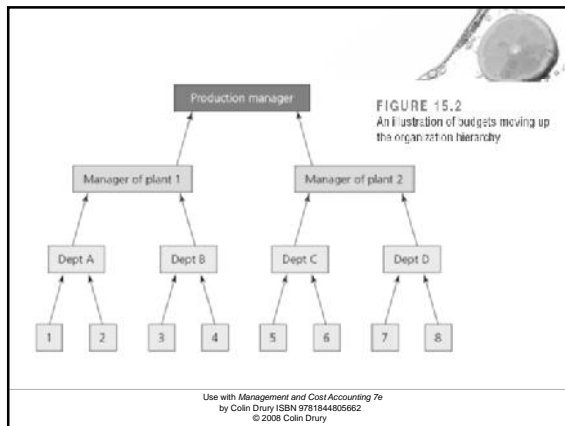


ABB involves the following stages:

1. Estimate the production and sales volume by individual products and customers.
2. Estimate the demand for organizational activities.  
(e.g. Process 5,000 customers' orders for the customer order processing activity)
3. Determine the resources that are required to perform organizational activities.  
(e.g. 0.5 hours per order =  $5,000 \times 0.5 \text{ hours} = 2,500$  labour hours for the customer processing activity must be supplied)

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### Activity-based budgeting (ABB)

- Conventional budgeting is inappropriate for those activities where the consumption of resources does not vary proportionately with the volume of the final output of products or services.
- For support activities conventional incremental budgets merely serve as authorization levels for certain levels of spending.
- Incremental budgeting results in the cost of non-unit level activities becoming fixed.
- ABB aims to authorize only the supply of those resources that are needed to perform activities required to meet budgeted production and sales volumes.

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4. Estimate for each resource the quantity that must be supplied to meet the demand.

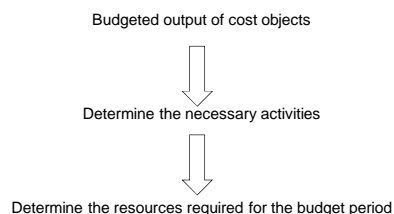
(e.g. Assume a step cost function with each person employed contracted to work 1,500 hours per year so that quantity of resources required =  $2,500/1,500 = 1.67$  persons meaning that 2 persons must be employed)

5. Take action to adjust the capacity of resources to match the projected supply.

(e.g. If 3 persons are presently employed on the activity resources must be reduced, or redeployed, by one person)

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- The ABB process is the reverse of the ABC process:



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- Periodically actual results should be compared with an adjusted (flexible) budget.


*Example*

Budgeted activity for processing orders	= 2,800 orders
Orders processed per person	= 600
Resources required	= 4.67 persons
Resources supplied	
(practical capacity for 3,000 orders)	= 5 persons
Employment costs (£25,000 per person per year)	= £125,000
Cost driver rate (£125,000/3,000 orders)	= £41.67
Actual orders processed for the period	= 2,500 orders

Performance report:

Flexed budget ( $2,500 \times £41.67$ )	= £104,175
Budgeted unused capacity ( $3,000 - 2,800$ ) $\times$ £41.67	= 8,334
Unplanned unused capacity ( $2,800 - 2,500$ ) $\times$ £41.67	= 12,491
	<u>125,000</u>

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- Above represent committed resources but for flexible resources (e.g.office supplies) resources supplied can be matched exactly to resources demanded.
- See sheet 8 for an illustration of an activity-based budget for an order processing activity.

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EXHIBIT 15.1 Activity-based budget for an order receiving process

Activities →	Handle import goods	Execute express orders	Special Deliveries	Distribution administration	Order receiving (standard products)	Order processing (non-standard products)	Execute rush orders	Total cost
Resource expense accounts:								
Office supplies								
Telephone expenses								
Salaries								
Travel								
Training								
Total cost								
Activity cost driver → measures	Number of customs documents	Number of customer bills	Number of letters of credit	Number of consignment notes	Number of standard orders	Number of non-standard orders	Number of rush orders	

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Thank You for your attention!

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