

## Chapter 8 Solutions

### Solution 8.1

#### *a) Outline the main objectives of budgetary planning*

CIMA defines planning as ***'the establishment of objectives, and the formulation, evaluation and selection of the policies, strategies, tactics and action required to achieve them'***. Planning can be both short term and long term in focus. The main objective of budgeting is to provide a formal quantitative and authoritative statement of the firms plans expressed in monetary terms. A budget is a quantitative expression of a proposed future plan put forward by management for a limited period. It acts as a blueprint for a business to follow in future periods. The plan of action selected is termed the 'fixed budget' or 'master budget' for the period.

#### *b) Distinguish between budgetary planning and budgetary control*

Budgetary planning facilitates a business developing plans for the future. Planning provides a focus for a business. It provides objectives or goals which the business should see as the stepping stones to achieving its strategy. A business is unlikely to be successful unless its managers have a clear plan regarding its future direction. Plans require financial resources (money) and generally the financial resources of a business are limited. Thus it is essential to evaluate the financial implications of pursuing each course of action open to the business. In so doing, a business can select the course that hopefully will achieve its strategic objectives. Budget planning involves the preparation of a master budget sets out the plans for the business for the next accounting period based on various assumptions of sales and sales growth, inflation (in particular labour inflation), interest rates, taxation and capital expenditure. However budgetary planning is only one part in the overall budgetary process. Budgetary control is also essential because actual performance needs to be monitored and compared to the budgeted targets set to evaluate the performance of the business. Actual performance will always differ from the fixed budget as the business environment is quite dynamic and thus events and conditions may not turn out as anticipated in the budget. It is important that actual events in a budget period are monitored against the budget plan so that timely action can be taken to remedy or improve the situation. Budgetary control is concerned with the manner in which budgets are used as a tool of management.

## Solution 8.2

### *a) Distinguish between short-term and long-term planning*

Strategic or corporate planning is concerned with the objectives of a business and the long-term plans to achieve these objectives. Strategic planning covers periods greater than one year. Strategic planning involves setting business objectives, the identification evolution and selection of strategies to achieve the objectives. The level of detail in strategic plans is not as great as in short-term plans. Effectively, short-term plans flesh out the long-term plans of a business and cover the immediate period and would be for one year. Short-term planning involves preparing projections for the next twelve months. These projections are generally quite detailed and are expected to be reasonably accurate, as the planning period is quite short. Short-term plans are effectively long-term plans broken into smaller time periods and are essential in terms of appraising short-term performance and acting as a benchmark for performance evaluation. The annual budget is generally divided into twelve monthly or thirteen four-weekly time periods.

### *b) What is the master budget and describe its role in relation to other budgets*

The master budget comprises of a set of projected financial statements or budgets that portray the predicted financial outcomes of pursuing the selected strategies for the year in question. The projected financial statements will normally comprise of:

- A projected profit and loss account.
- A projected balance sheet.
- A projected cash budget.

The master budget presents a financial picture of what the company wants and reasonably expects to achieve in the time period allotted, based on certain assumptions regarding economic and political conditions.

## Solution 8.3

### *a) Identify the key steps in the development of a financial plan*

The following are the most important steps in the development of a financial plan/budget.

**Communicate details of budget policy and guidelines:** This is where management will communicate the long-term or strategic plan and the consequences of this plan, to those responsible for preparing annual budgets. The consequences for example, may be a focus on different products / markets or contraction and expansion for key activities. Guidelines must also be communicated in terms of what assumptions to make in preparing the annual budget. This can include recommendations on sales prices or wage rates etc.

**Identify limiting factors:** A key task is to identify the principle budget factors, also known as the limiting budget factors. Every organisation has a limiting factor(s), a constraint that prevents it from expanding at the time the budget is prepared. A limiting factor would be a variable that impedes the operation or growth of a business. Examples include sales demand, labour, materials or operational constraints.

**Preparation of sales budget :** This is the most important budget as it determines the level of a company's operations and thus many of its costs and capital commitments. Estimates need to be made on sales volume, sales mix and sales price. This is extremely difficult to do and requires great knowledge of the market and the company's customers. If a constraint other than sales demand exists, it is vital to ensure that the sales budget is prepared with full consideration of the impact of the constraint.

**First draft preparation of department budgets;** This involves each department or cost centre preparing their own budgets based on, the activity level agreed in the sales budget, the limiting factors identified and the guidelines set out in stages one, two and three. These budgets will be mainly cost (expense) budgets with various revenue producing departments also showing how they propose to achieve the sales targets set out in the overall sales budget. For example in a hotel, all the departments will produce expense budgets, however only the revenue producing departments such as restaurant, bar, leisure centre or accommodation will also produce sales revenue targets in line with the overall sales target agreed. Budgets laying out capital commitments and spending plans for the period will also be included in the first draft budget.

**Budget negotiation :** In the preparation of budgets there should always be a negotiation procedure. At each stage the budget will be negotiated between the manager who submits and the direct superior. Thus the final agreed figures in the budget are as a result of a

bargaining process between a manager and his or her superior. If this bargaining process does not take place then it is likely that managers will be unmotivated in terms of achieving their budget.

**Co-ordination and review of budgets:** The co-ordination of budgets ensures that each budget agreed is likely to ensure the annual target is achievable and that this fits in with the overall strategic plan. If some budgets are out of balance with the overall annual target then these need to be modified and revised so that they are compatible with the overall targets, policies and limiting factors agreed at stages one and two.

**Final acceptance of budget:** When all budgets are prepared, agreed and revised if necessary, they are summarised into the master budget which consists of a budgeted profit and loss account, balance sheet and cash flow statement. Once the master budget is accepted then the various budgets that make up the master budget are passed down through the organisation to the appropriate departments or cost centres.

***b) Outline the administrative back-up procedures that need to be implemented to ensure the budget process works effectively***

To ensure that the budgetary process operates efficiently, suitable administration procedures should be implemented. These procedures should support management in the preparation of budgets and layout the process by which budgets are approved. The budget process should have the following administrative supports:

**A budget committee** should consist of senior management who are responsible for the major functions of the organisation. For example management representing such segments as production, administration, finance, marketing and sales etc., should be part of the budget committee. Generally the committee will appoint a budget officer (normally an accountant) who co-ordinates the individual budgets into the master budget. The procedure is that each member of the budget committee is responsible for a segment or department of the business. Each segment submits a budget and thus each member of the budget committee can not only see their budget, but also the other budgets submitted and see the overall effect in the master budget. It is here that the final budgets are agreed and if any budget does not reflect a reasonable level of performance then it will not be approved and will require adjustment and resubmission. The budget committee also sets the guidelines for the preparation of individual budgets and the procedures for negotiating and agreeing budgets.

**Accounting staff** should be available to management as they prepare their individual budgets. Their role is not to determine the content of the budget but to provide advisory, accounting support.

**A budget manual** outlines the objectives, rules, regulations and procedures involved in the budgetary process. It is generally prepared by the company accountant and in addition to the above, would include timetables regarding the process, highlighting important dates as well as identify persons responsible for the various budgets to be submitted.

## Solution 8.4

*What do you understand by the term 'responsibility accounting' and how does it help the budget process*

Budgeting works best where a clear organisation structure exists and where clear lines of responsibility are laid out. An organisation structure is an arrangement of lines of responsibility within the company or department. Each manager within the organisation is in charge of, or responsible for, a part or segment of the organisation and thus that part could be called a responsibility centre. Responsibility centres can be cost centres, revenue centres, profit centres or investment centres.

Responsibility accounting measures actual results with budgeted for every responsibility centre and ultimately helps to trace costs and revenues to the person who has the most knowledge of, and who is responsible for, those costs and revenues. Budgets coupled with responsibility accounting, provide a focus for managers when interpreting variances. Variances, whether positive or negative, should prompt questions and subsequent investigation, not blame. Thus responsibility accounting identifies a person who can properly explain a variance. It is of utmost importance with responsibility accounting that all non-controllable costs within a responsibility centre are separately identified and not included as part of any performance review of that centre.

## Solution 8.5

*Circumstances which could cause the whole budgeting process to have a demotivating effect on management and employees within an organisation*

- Where the process of target setting is a top-down approach with management deciding targets for their subordinates.
- Where unrealistic targets are set resulting in an idealistic budget rather than an attainable or realistic budget.
- Where the expectation in the work environment is that targets must be met above all other things. In this instance managers will introduce 'slack' into the target setting process to ensure the target is achieved.
- Where a critical approach is taken when targets are not achieved.

## Solution 8.6

### *Distinguish between a bottom-up and a top-down approach to budget implementation*

CIMA define a **bottom-up approach** to budgeting as *'a budgeting process where all budget holders have the opportunity to participate in setting their own budgets'*. Where a bottom-up (participative) approach is adopted, budgets are developed by lower-level managers who then submit and agree their budgets with their superiors. This approach can be effective in very large organisations or where operational managers have strong budgeting skills.

A **top-down approach** to budgeting has been defined by CIMA as *'a budgeting process where budget allowances are set without permitting ultimate budget holders the opportunity to participate in the process'*. When a top-down (imposed) approach is adopted, senior management prepare a budget with little or no input from operating personnel. The budget is then imposed on employees who have to work to the budget figures. This imposed approach can be effective in newly formed or small organisations during economic hardship when precise co-ordination is required, or when operational managers lack budgeting skills.

A bottom-up approach encourages participation in the budget process while a top-down approach imposes a budget without allowing participation.