

Steps and Procedures for Forecasting, Budget Preparation and Budgetary Control

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Steps and Procedures for Forecasting, Budgets Preparation and Budgetary Control

- **All organisations and businesses have to perform some form of forecasting and planning. Even if it is only forecasting one or two days ahead and then planning how they are going to achieve the results of these forecasts**

FORECASTING

- **The first step in the preparatory process**
- **Highlights the sources of information and data**
- **Should involve**
 - Statistics from previous years
 - Current trends
 - Technological and other influences

SALES BUDGETS

- **Product by product description**
- **Sales areas and if possible the managers covering those areas**
- **Number and type of units**
- **Sales pricing policy**
- **Monthly or period statistics of unit sales and values**

PRODUCTION BUDGETS

- **Uses details of the manufacturing and purchasing of the products required to meet the targets set in the Sales Budgets**
- **Broken down into the constituent parts as required to assess the costs involved**
 - **Purchasing Budget**
 - **Production Labour Budget**
 - **Production Department Overheads Budgets**
 - **Machinery requirement and/or Processing Activity Budget**

ADMINISTRATION and OTHER DEPARTMENTAL BUDGETS

- **Overhead departments**
 - Accounts Budgets
 - Personnel Budgets
 - Research and Development Budgets
 - Other departments such as the Stores and Transport Budgets

Variations

- **Actual Accounts would be prepared and analysed to give actual numbers in a format to make a like for like comparison to the budgets**
- **Variations (the differences between Actual and Budget) can be ascertained.**

FIXED AND VARIABLE COSTS

- **Fixed** - the cost item would be fixed over a period of time and it does not vary with levels of selling, production or any other activity.
- **Variable** - the item may vary proportional to the levels of production and/or sales.
- **Semi Variable** – an element of the cost is fixed and part of it is variable i.e. a telephone bill with a fixed line rental.

Examples of Fixed and Variable costs

- **Rent and rates for premises are for a Fixed period of time**
- **Telephone Rental is Fixed for a period of time**
- **Telephone calls are Variable and to some extent reflex the activity of the sales and production**
- **Administration staff costs are generally accepted as Fixed**
- **Production personnel fall into Fixed, and Semi-Variable as Direct Labour is now subject to contract agreements and not directly variable to output. Piece work or overtime costs would probably be Variable**
- **Sub-Contractors cost would probably be wholly Variable**

STANDARD COSTING

- **A management tool to breakdown into definable units the expected or desirable cost of each controllable element making up the total costs to produce a “unit of sale”. What this means is as follows:**
 - First define the physical aspect of the product into a controllable measure
 - Does “each” mean that it is a single unit, for example a Widget?
 - Define the extent of “each” is it a single unit or another measure like metres, litres, or packs of say ten or a hundred
 - Allowances would be assessed for wastage spoilage and evaporation etc
 - This final unit measure must be applied to the product throughout its Standard Cost evaluation

STANDARD COSTING

- **The second task is to obtain or assess the costs applicable to the UNIT measure established.**
- **The cost should be the same cost applicable to varying levels of production or output (Marginal Cost per unit).**
- **This means that the standard cost to produce a single unit should be the same standard cost per unit to produce a thousand units. The minimum breakdown of costs should be:**
 - **Material Cost** Generally the total cost delivered to the works
 - **Labour Cost** Gross wages plus allowances for holidays and other agreed absences
 - **Variable Overhead Cost** Employers National Insurance and holidays etc if not included in
 - **Labour Cost**

STANDARD COSTING

- **These unit costs can be established by extrapolation from previous purchases and labour rates or even forward purchasing deals and agreements with suppliers and Trade Unions.**
- **They can be ascertained by dividing the Budgeted units to be produced or sold, into the Budgeted values for production or sales, to give an average which could be set as the Standard Cost.**
- **Likewise it is possible that the sales budget could be made up from the standard costs multiplied up by the sales units to give total Budgeted Sales, chicken or egg.**

KEY PERFORMANCE INDICATORS (KPIs)

- **Every Budget or Standard Cost has one or more KPIs**
- **These KPIs control the extent of the other costs and values.**
 - A simple example would be the nodding rate of a machine which can only be set to produce say 100 units per minute. This would be a KPI, although the output could be reduced, it would need another machine or replacement if more than 100 units per minute were required.
 - It is important to know the key factors as they would probably be the reasons why the differences occurred between the actual results and the budget or standard cost.

JOB COSTING

- **This is the description given to the costing system used to control the basis on which the measurements are made.**
 - i.e. the sales and production is by definable and controllable units which are known as jobs.

PROCESS COSTING

- **This is the system that recognises the production process cannot be broken down into definable jobs, and uses its base measurement as a BATCH or period e.g. a days' production process, which may then be measured in units at its final stage.**
 - A continuous manufacturing process (e.g. ball milling powder) would be measured by the final packaging or sales unit e.g. carton or drum. It is almost impossible to get 112 1lb bags of sugar from a one cwt sack.

MARGINAL COSTING

- **This is probably the only way that certain industries can establish a period profit.**
- **It is not always possible to ascertain stock or working progress valuations at the monthly accounting period end.**
- **The cost of sales is taken as the variable cost of the actual sales value.**
 - If in a period the total sales units were 1,000 and the sales value in the period is say £100,000 the assumed average sales value is £100. If the budgeted or standard Variable costs per unit is £40 then 1,000 units at £40 would be the Marginal Cost of Sales i.e. ££40,000. This would give a Marginal Profit of £60,000 i.e. 60% on sales value.

MANAGEMENT BY EXCEPTION

- **For companies and businesses that operate some form of budgetary control with or without standard costing should apply management by exception, as this is what the process is designed to achieve.**
- **It means that when the actual results and budgeted results are compared and variances are produced, the management needs to concentrate first on the largest variance amounts to achieve greater savings.**
- **If the variance is very small don't waste time looking into the reasons for difference. If it's not broken don't fix it.**

STANDARD COSTING VARIANCES

- **By comparing the actual results achieved in an accounting period with the budgeted results that have been built up from standard costs, it is possible to obtain some of the following variance for a given accounting period**
- **Sales Total Variance**
 - The difference between the actual sales and budgeted sales
- **Sales Volume Variance**
 - The difference between actual sales units and budgeted sales units valued at standard unit sales value
- **Sales Price Variance**
 - The actual sales units valued at the difference between the actual sales value per unit and budgeted sales value per unit
- **Technology Variance**
- **There are many other variances that can be assessed if the Standard details and Actual details are defined and these can be extracted and compared. An example would be a change in an electronic part from the specification when the Standard was set, to a revised specification due to the rapid advances in electronic sciences.**

EXAMPLE

	Budget	Actual	Difference	
• Sales units	1000	1150	150	favourable Volume
• Sales value per unit £100		£95	£5	unfavourable Price
• Total sales value	£100,000	£109,250	£9,250	favourable Total
• Volume Variance	150 @ £100		£15,000	favourable
• Price Variance	£5 @ 1150		(£ 5,750)	unfavourable
• Total Variance			£ 9,250	favourable

BUDGETARY CONTROL

- **This is the process of comparing the actual results in a given period with the Budgets for the same period and expressing the differences as variances better/(worse) than budget.**
- **Often expressed in two sets of columns being the current control period of a week or month and the year to date**

BUDGETARY CONTROL

	Month			YTD 6 months		
	Actual	Budget	Variance	Actual	Budget	Variance
	£	£	£	£	£	£
Sales	900	1000	(100)	6200	6000	200
Cost of Sales	<u>180</u>	<u>200</u>	<u>20</u>	<u>1100</u>	<u>1200</u>	<u>100</u>
Gross Margin	<u>720</u>	<u>800</u>	<u>(80)</u>	<u>5100</u>	<u>4800</u>	<u>300</u>
Variable Overheads	350	300	(50)	2000	1800	(200)
Fixed Overhead	<u>300</u>	<u>300</u>	<u>0</u>	<u>1900</u>	<u>1800</u>	<u>(100)</u>
Total Overheads	<u>650</u>	<u>600</u>	<u>(50)</u>	<u>3900</u>	<u>3600</u>	<u>(300)</u>
Net Profit(Loss)	<u>70</u>	<u>200</u>	<u>(130)</u>	<u>1200</u>	<u>1200</u>	<u>0</u>

FLEXIBLE BUDGETING

- **This is a process of flexing the variable budget units to the actual unit sales in the period.**
- **Flexible budgeting effectively takes out the volume variance, so the calculated variances now represent price and cost differences.**
- **The volume variance is therefore eliminated.**
 - If in the example above the budgeted unit sales value was £1, and the Cost of Sales and Variable overheads were recovered as a percentage of the sales value, then the budgeted sale units for the month would be 1000 and year to date 6000. The percentage Cost of Sales remains at 20% and variable overheads at 30%. If the units sold in the month is 890 and YTD is 5900.

FLEXIBLE BUDGETING

	Month			YTD 6 months		
	Actual Budget Variance			Actual Budget Variance		
	£	£	£	£	£	£
Sales	900	890	10	6200	5900	300
Cost of Sales	<u>180</u>	<u>178</u>	<u>(2)</u>	<u>1100</u>	<u>1180</u>	<u>80</u>
Gross Margin	<u>720</u>	<u>712</u>	<u>8</u>	<u>5100</u>	<u>4720</u>	<u>380</u>
Variable Overheads	350	267	(83)	2000	1770	(230)
Fixed Overheads	<u>300</u>	<u>300</u>	<u>0</u>	<u>1900</u>	<u>1800</u>	<u>(100)</u>
Total Overheads	<u>650</u>	<u>567</u>	<u>(83)</u>	<u>3900</u>	<u>3570</u>	<u>(330)</u>
Net Profit(Loss)	<u>70</u>	<u>145</u>	<u>(75)</u>	<u>1200</u>	<u>1150</u>	<u>50</u>

FLEXIBLE BUDGETING

- **It is of course possible to flex the actual expenditure or sales revenue to meet the budget, by the use of monthly and YTD accruals, prepayments and Work in Progress.**
- **This may be necessary when an item of expenditure is of an annual or bi-annual nature such as Insurance, and the budget assessment amount, has taken these possible changes into account.**
- **Also there may be a major change in the company structure or new products are introduced or a reduction in some products due to supply or technology.**

FLEXIBLE BUDGETING

- **It is pointless to make adjustments just to bring the actual into line with the budget.**
- **The purpose of investigation is lost and although for eleven months the variances are small, the truth will come to light on the final twelfth month and it could be too late to find out what has gone wrong.**

MONTHLY or SEASONAL VARIATIONS

- **Most companies suffer from the effect of outside influences that makes the annual turnover and variable costs values fluctuate from month to month or quarter to quarter.**
- **If this is important (e.g. horticultural nurseries with spring season sales) then the monthly/quarterly sales and other budgets can be adjusted to show the expected movement.**
- **This can be very important when considering cash flow projections.**
- **Alternatively the year can be split into thirteen 4 weekly months or a CALENDER VARIANCE calculated each month and YTD.**
- **After about 3 months into the trading year often the YTD figures intend to smooth out or show a trend.**

FIT FOR PURPOSE

- **A Budgetary Control and Standard Costing System must be designed to suit the level of Management who will use the information.**
- **If it is too complex then the benefits will be ignored, if it is too simple it will not produce enough information to indicate areas needing management attention.**
- **It may be better to save your breath and use it to blow on your porridge.**
- **An entrepreneur will probably only look at the Profit and Loss Statements and ignore the Balance Sheet, whereas an accountant, will generally look first at the assets and liabilities in the Balance Sheet before considering the turnover and profit or loss.**

The four “Cs”

- **CRITICAL**
- **CRISIS**
- **CALAMITY**
- **or CRUCIAL**
- **Rolling Four accounts – the next 4 months budget figures are revised in light of current information**
- **Always consider the COST OF COSTING.**

RATIOS, PERCENTAGES AND STATISTICS

- **These are the indicators that make comparisons between Turnover, Profit, Assets and Liabilities to assess trends, and the inter-relationship between revenue figures and balance sheet items, and are useful as inter firm or trade comparisons.**
- **Ratios can be turned into percentages by multiplying a ratio figure by 100.**

RATIOS, PERCENTAGES AND STATISTICS

- **Revenue/Revenue**
- **Gross Profit (Margin) Ratio** **Gross margin** : **Total Sales**
- **Net Profit Ratio** **Net profit (before tax)** : **Total Sales**
- **Profit Mark up** **Gross Profit (Margin)** : **Cost of Sales**

RATIOS, PERCENTAGES AND STATISTICS

- **Revenue/Balance Sheet**
- **Return on shareholders' funds** **Net income (profit after tax)**
: **Shareholders' Equity**
- **Return on Capital Employed** **Net profit (before tax) :**
Total assets less current liabilities
- **Stock Turnover** **Annualised Cost of goods sold :**
Average Stock Valuation
- **Debtors Turnover** **Annualised Credit Sales :**
Average Debtors Valuation
- **Creditors Turnover** **Annualised Cost of Sales :**
Average Creditors Valuation

RATIOS, PERCENTAGES AND STATISTICS

- **Balance Sheet/Balance Sheet**
- **Current Ratio** **Current Assets : Current Liabilities**
- **Quick Ratio** **Current Assets (less Stock) : Current Liabilities**
- **Debt to Equity Ratio** **Total Debt : Total Equity**
- **Gearing Ratio (Borrowing)** **Total Loans : Equity**

