Corporate Finance – Semester 2

**BUDGETING PROCESS**

The following topics will be discussed in this lecture.

* Budgeting process
* Purpose / functions of budgets
* Cash budgets – Preparation & interpretation

**The Budget Process**

The Budget process allows the company to:

* set its fiscal objectives in respect of revenue, expenditure, debt repayment and investment;
* maintain an effective fiscal control and plan for the coming year and beyond;
* allocate the available resources, consistent with the Company's strategic objectives and priorities;
* fulfill the legislative requirements for the Budget; and
* Seek authority from Parliament for spending.

All Managers have a key role in the budget process. Together, they agree on the budget strategy and priorities for spending. On an individual level, Managers identify priorities for departmental chief executives to guide preparation of Budget submissions.

**Budget Preparation Process:**

**1. Budget Policy & Details – Communicating To All**

This includes disseminating details like the budgeting period, time table and formation of budgeting committee.

The main objective is to make clear of the scope and roles of people involved in this process. Normally, budgeting period is a period of 12 months. It may be calendar year or any combination of 12 months. However, it is always broken down into 12 periods of one month or into quarters because of comparison with actual performance and control purposes.

This process is formalized by forming a committee comprising of different front line managers and a very senior person is appointed to head this committee. Such a person should have a clear vision of future and unambiguous understanding of corporate objectives. Budgets are used to translate the ultimate objectives into monetary terms as a course of action to accomplishment of those objectives.

A budget has to be finalized before the start of the period for which it is being prepared. For example, budget for 2006 must be completed before January 2006. The time to complete budget will vary firm to firm, on the type of budget and the budget period. There are different phases in budget preparations and timeliness is set for each phase.

**2. Determining The Limiting Factor**

Budget preparation normally begins with the identification of limiting factor. This refers to a factor that limits the stretch of company or hinders company’s achievement of specific objective. The first step will be to determine the sales during the budget period. The first question will be “do we have the capacity to produce this much?” Assuming that the answer is “no” then, production capacity is the limiting factor. You can’t achieve what you have determined and need to cut-down your plans or revise your target sales.

The other areas may be the availability of labor force and/or raw materials. If there’s no limiting factor then company can start with the target sales and if there’s one that hampers target, then it would be what can be achieved with the available resources.

**3. Production Budget Preparation**

The primary source of inflow comes from the principal activity or sale of goods. Therefore, in budget preparation sales is the kick off point.

Sales budget is prepared in quantitative form. Each product sales is mentioned in number of units to be produced. There is a standard specification of a unit in terms of the input material requirements; labor time and amount of overhead needed to manufacture it. There’s also a standard selling price of each product unit.

Sales in monetary term are calculated by multiplying number of units to be produced by standard selling price.

Next step will be to determine the expense side of number of units to be produced in the budget period. This is known as production cost budget and is divided into three categories.

First step will be to determine the total raw material requirements by multiplying the number of units to be produced by standard quantities of input materials. The dollar value of direct material cost is calculated by multiplying derived quantities by the standard purchase price.

In second step, direct material requirements are worked out. Standard time to produce one unit is multiplied with number of units to be produced. The total production hours are multiplied by standard labor rate per hour to reach at total labor cost.

The third segment in cost of sales determination is to estimate the overhead to be absorbed per unit of output. This is normally done by dividing the estimated amount of overheads by the activity level – labor hours.

Adding these three segments – direct materials, direct labor and overhead render total cost of production.

**4. Other Ancillary Policy Issues Determination**

The other items that are determined in this phase includes but not limited to the minimum level of finished goods level, purchases of each raw materials and raw material ending inventory levels.

**5. Functional Budgets & Negotiation**

After the sales and production cost budget has been determined then comes the step where individual departments or functional budgets are prepared. Every functional manager is required to prepared and present before the budget committee budget for the forthcoming period.

**6. Adjustments & Trimming**

Once the sales, production cost and functional budgets have been submitted to the committee then there are discussions and negotiations and adjustments are made in the light of available resources and short term objective of the firm. If there is shortage of resources then departmental budgets are trim down. At the point where the tradeoff between resources and resource utilization is achieved, it is deemed as final.

**7. Finalization Of Budget & Implementa**tion

Final version of budget is presented to head of committee who then present it to chief executive officer. If CEO has some reservations it may ask for reconsideration or can approve as is. After CEO ratification the budget is approved for implementation.

**8. Variance Analysis & Investigatio**n

After the budget is approved and implemented, the actual performance is compared with the budgeted one and variances are calculated. Variance is the difference between the actual and budgeted numbers. The variance is investigated as to know the root cause of difference. The information is used to adjust the next budgets period.

**Specific Phases of the Budget**

The Budget process can be divided into distinct phases:

**Common Purposes/Functions behind Budget Activity**

**Planning** -- involves determining organizational and program objectives and evaluating alternative meansfor their achievement. Planning also includes prioritizing.

**Control** -- defined as monitoring, comparing information to a standard and taking corrective action. For a **budget** to serve this function well it must have four characteristics:

It must be well-conceived (i.e., result from a good planning process) and be approved by the board It must be broken down into increments corresponding to the periodic financial statements Financial statements must be prepared on a timely basis and compared to the **budget**

The board and staff must take action where such comparison indicates a potential problem. **Management** -- allocating resources deliberately and prudently to achieve program objectives.

This includes programming approved goals into specific projects and activities, the design of organizational units to carry out programs, staffing, and procurement of resources.

**Cash Budgets**

**An Introduction to Preparing Cash Budgets**

When many people first have to prepare a cash budget or a cash flow statement they start out thinking that they're easy to do. Half way through, though, a mist seems to settle over their eyes and they become impossible to do.

The problem usually comes down to matters such as the layout, the balances brought down and carried down and the debtors and creditors.

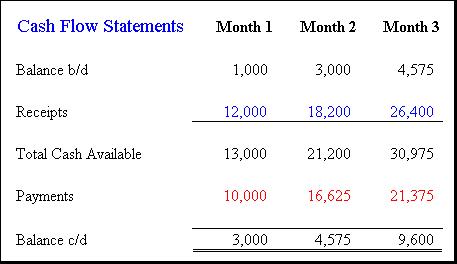
Most things to do with the cash itself are simple to account for: the day we receive the cash, we put it into the statement; the day we pay some cash, we put that in the statement ... that's pretty well all there is to do with the cash itself.

OK, so the cash itself is simple to deal with but there is still a lot more to be worried about I can hear you screech! Fear not, though, help is at hand on this very page.

We'll start by taking a look at the layout and contents of cash budget overall. Then we'll have a look at an alternative layout, remembering that whatever the layout, they should all give the same answer! Finally, we'll spend some time solving all of your debtor and creditor worries!

**Overall Layout of a Cash Budget**

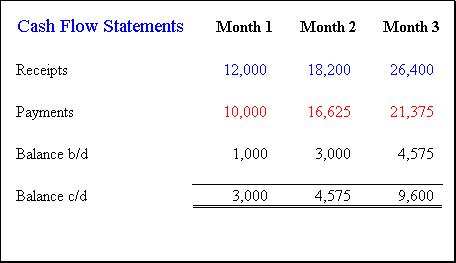
Here we have a cash budget statement that starts with the cash balance brought down (b/d) from last month, last week or yesterday (this is the cash we had in the safe or our purse or wallet at the end of the previous period). Then we add the cash receipts to the balance b/d to give us the total amount of cash we then have available to us: this is the amount of money we can spend.



However, we usually have bills to pay, so we take away from the cash available the amount of money we have to pay for our bills, utilities, materials, labor and so on. Starting with the balance b/d adding the receipts and taking away the payments leaves us with the balance carried down (C/D); and this is what we have left at the end of the month ready for use at the start of the following month.

**Alternative Layout of a Cash Budget**

In addition to dealing with debtors and creditors, which we will deal with shortly, there is the key issue of alternative layouts. Here we see an alternative layout that has exactly the same information in as the previous example but they are presented in a different order.



Most importantly, though, the balances C/D at the end of each month are the same whichever layout we use. Just compare this new layout and the balances C/D with the previous layout we saw above.

**Cash Flow Statement**

This statement is governed by international accounting standard # 7

* Purpose of cash flow statement is to provide information about the inflows and outflows of cash and cash equivalents. The inflows and outflows are grouped into three categories.
* Cash & cash equivalents are short term, highly liquid investments that are both readily convertible to cash and without loss of value.
* Statement is divided into three categories

– operating activities

– investing activities

– financing activities

* Purpose of cash flow statement
* To identify and assess the ability to generate future net cash flow from operations to pay debt, interest and dividends
* External financing requirements
* To see the effects of cash & non cash investing and financing transactions.
* Assess the reasons for differences between income and associated cash receipts and payments