19 BUDGETING AND BUDGETARY CONTROL

Budgeting is used by businesses as a method of financial planning for the future. Budgets are prepared for main areas of the business – purchases, sales, production, labour, debtors, creditors, cash – and provide detailed plans of the business for the next three, six or twelve months. The focus of this chapter is the cash budget.

In this chapter we shall be examining:

- the benefits of budgets and budgetary control
- the limitations of budgets and budgetary control
- the preparation and use of cash budgets

INTRODUCTION TO BUDGETS

Businesses need to plan for the future. In large businesses such planning is very formal while, for smaller businesses, it will be less formal. Planning for the future falls into three time scales:

- **long-term**: from about three years up to, sometimes, as far as twenty years ahead
- **medium-term**: one to three years ahead
- **short-term**: for the next year

Clearly, planning for these different time scales needs different approaches: the further on in time, the less detailed are the plans. In the medium and longer term, a business will establish broad **business objectives**. Such objectives do not have to be formally written down, although in a large business they are likely to be. In smaller businesses, objectives will certainly be considered and discussed by the owners or managers. Planning takes note of these broader business objectives and sets out how these are to be achieved in the form of detailed plans known as **budgets**.

In this chapter we are concerned with planning for the more immediate future, ie the next financial year.

What is a Budget?

A budget is a financial plan for a business, prepared in advance.

A budget may be set in money terms, eg a sales budget of £500,000, or it can be expressed in terms of units, eg a purchases budget of 5,000 units to be bought.

Budgets can be **income** budgets for money received, eg a sales budget, or **expenditure** budgets for money spent, eg a purchases budget.

The budget we shall be focusing on in this chapter is the **cash budget**, which combines both income and expenditure, estimating what will happen to the bank balance during the time period of the budget.

Most budgets are prepared for the next financial year (the **budget period**), and are usually broken down into shorter time periods, commonly four-weekly or monthly. This enables **budgetary control** to be exercised over the budget: the actual results can be monitored against the budget, and discrepancies between the two can be investigated and corrective action taken where appropriate.

Benefits of Budgets and Budgetary Control

Budgets provide benefits both for the business, and also for its managers and other staff:

the budget assists planning

By formalising objectives through a budget, a business can ensure that its plans are achievable. It will be able to decide what is needed to produce the output of goods and services, and to make sure that everything will be available at the right time.

the budget communicates and co-ordinates

Because a budget is agreed by the business, all the relevant managers and staff will be working towards the same end.

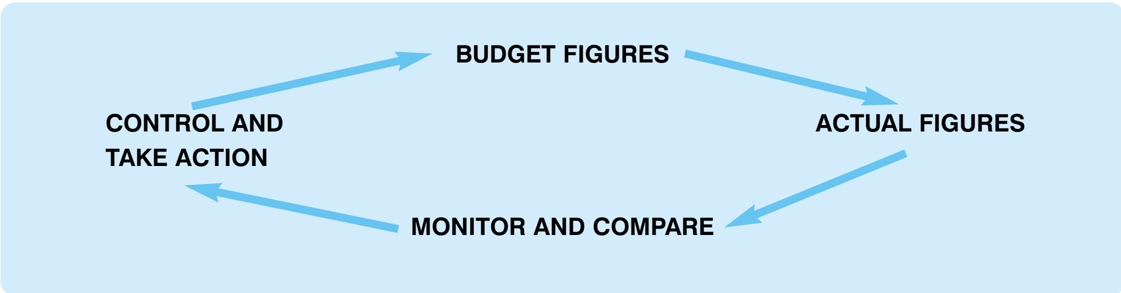
When the budget is being set, any anticipated problems should be resolved and any areas of potential confusion clarified. All departments should be in a position to play their part in achieving the overall goals.

the budget helps with decision-making

By planning ahead through budgets, a business can make decisions on how much output – in the form of goods or services – can be achieved. At the same time, the cost of the output can be planned and changes can be made where appropriate.

the budget can be used to monitor and control

An important reason for producing a budget is that management is able to use budgetary control to monitor and compare the actual results (see diagram below). This is so that action can be taken to modify the operation of the business as time passes, or possibly to change the budget if it becomes unachievable.



the budget can be used to motivate

A budget can be part of the techniques for motivating managers and other staff to achieve the objectives of the business. The extent to which this happens will depend on how the budget is agreed and set, and whether it is thought to be fair and achievable. The budget may also be linked to rewards (for example, bonuses) where targets are met or exceeded.

LIMITATIONS OF BUDGETS AND BUDGETARY CONTROL

Whilst most businesses will benefit from the use of budgets, there are a number of limitations of budgets to be aware of:

the benefit of the budget must exceed the cost

Budgeting is a fairly complex process and some businesses – particularly small ones – may find that the task is too much of a burden in terms of time and other resources, with only limited benefits. Nevertheless, many lenders – such as banks – often require the production of budgets as part of the business plan. As a general rule, the benefit of producing the budget must exceed its cost.

budget information may not be accurate

It is essential that the information going into budgets should be as accurate as possible. Anybody can produce a budget, but the more inaccurate it is, the less use it is to the business as a planning and control mechanism. Great care needs to be taken with estimates of sales – often the starting point of the budgeting process – and costs. Budgetary control is used to compare the budget against what actually happened – the budget may need to be changed if it becomes unachievable.

the budget may demotivate

Employees who have had no part in agreeing and setting a budget which is imposed upon them, will feel that they do not own it. As a consequence, the staff may be demotivated. Another limitation is that employees may see budgets as either a 'carrot' or a 'stick', ie as a form of encouragement to achieve the targets set, or as a form of punishment if targets are missed.

budgets may lead to disfunctional management

A limitation that can occur is that employees in one department of the business may over-achieve against their budget and create problems elsewhere. For example, a production department might achieve extra output that the sales department finds difficult to sell. To avoid such disfunctional management, budgets need to be set at realistic levels and linked and co-ordinated across all departments within the business.

budgets may be set at too low a level

Where the budget is too easy to achieve it will be of no benefit to the business and may, in fact, lead to lower levels of output and higher costs than before the budget was established. Budgets should be set at realistic levels, which make the best use of the resources available.

WHAT BUDGETS ARE PREPARED?

Budgets are planned for specific sections of the business: these budgets can then be controlled by a **budget holder**, who may be the manager or supervisor of the specific section. Such budgets include:

- purchases budget – what the business needs to buy to make/supply the goods it expects to sell
- sales budget – what the business expects to sell
- production budget – how the business will make/supply the goods it expects to sell
- labour budget – the cost of employing the people who will make/supply the goods
- debtor budget – how much the business will receive from credit sales
- creditor budget – how much the business will pay for credit purchases
- cash budget – how much money will be flowing in and out of the bank account

The end result of the budgeting process is often the production of a **master budget**, which takes the form of forecast operating statements – forecast trading and profit and loss account – and forecast balance sheet. The master budget is the 'master plan' which shows how all the other budgets 'work together'.

Note that, in this chapter, we focus our attention on the cash budget; you will examine the other budgets, including the master budget, if you go on to study A2 Accounting.

Budgetary Planning

Many large businesses take a highly formal view of planning the budget and make use of:

- a **budget manual**, which provides a set of guidelines as to who is involved with the budgetary planning and control process, and how the process is to be conducted
- a **budget committee**, which organises the process of budgetary planning and control; this committee brings together representatives from the main functions of the business – eg production, sales, administration – and is headed by a budget co-ordinator whose job is to administer and oversee the activities of the committee

In smaller businesses, the process of planning the budget may be rather more informal, with the owner or manager overseeing and budgeting for all the business functions.

Whatever the size of the business it is important, though, that the planning process begins well before the start of the budget period; this then gives time for budgets to be prepared, reviewed, redrafted, and reviewed again before being finally agreed and submitted to the directors or owners for approval. For example, the planning process for a budget which is to start on 1 January might commence in the previous June, as follows:

- June — Budget committee meets to plan next year's budgets
- July — First draft of budgets prepared
- August — Review of draft budgets
- September — Draft budgets amended in light of review
- October — Further review and redrafting to final version
- November — Budgets submitted to directors or owners for approval
- December — Budgets for next year circulated to managers
- January — Budget period commences

Cash Budget

A cash budget sets out the expected cash/bank receipts and payments, usually on a month-by-month basis, for the next three, six or twelve months, in order to show the estimated bank balance at the end of each month throughout the period.

From the cash budget, the managers of a business can decide what action to take when a surplus of cash is shown to be available or, as is more likely, when a bank overdraft needs to be arranged.

layout of a cash budget

A suitable format for a cash budget, with sample figures, is set out on the next page.

Name ....Cash Budget for the .... months ending				
	Jan	Feb	Mar	Apr
	£000	£000	£000	£000
Receipts				
eg from debtors	150	150	161	170
cash sales	70	80	75	80
Total receipts for month (A)	220	230	236	250
Payments				
eg to creditors	160	165	170	170
expenses	50	50	50	60
fixed assets		50		
Total payments for month (B)	210	265	220	230
Net cash flow (Receipts less Payments, ie A–B)	10	(35)	16	20
Add bank balance at beginning of month	10	20	(15)	1
Bank balance (overdraft) at end of month	20	(15)	1	21

sections of a cash budget

A cash budget consists of three main sections:

- receipts for the month
- payments for the month
- summary of bank account

Receipts are analysed to show the amount of money that is expected to be received from cash sales, debtors, sale of fixed assets, capital introduced/issue of shares, loans received etc.

Payments show how much money is expected to be paid in respect of cash purchases, creditors, expenses (often described in cash budgets as operating expenses), purchases of fixed assets, repayment of capital/shares and loans. Note that non-cash expenses (such as depreciation and doubtful debts) are not shown in the cash budget.

The **summary of the bank account** at the bottom of the cash budget shows **net cash flow** (total receipts less total payments) added to the bank balance at the beginning of the month, and resulting in the estimated closing bank balance at the end of the month. An overdrawn bank balance is shown in brackets.

The main difficulty in the preparation of cash budgets lies in the **timing** of receipts and payments – for example, debtors may pay two months after date of sale, or creditors may be paid by the business one month after date of purchase: it is important to ensure that such receipts and payments are recorded in the correct month column.

Remember that the cash budget, as its name suggests, deals only in cash/bank transactions; thus non-cash items, such as depreciation, are never shown. Where cash discounts are allowed or received, only the actual amount of money expected to be received or paid is recorded. Similarly, where a business incurs bad debts, only the amount of money expected to be received from good debtors is recorded in the cash budget.

WORKED EXAMPLE: CASH BUDGET

situation

A friend of yours, Mike Anderson, has recently been made redundant from his job as a sales representative for an arts and crafts company. Mike has decided to set up in business on his own selling art supplies to shops and art societies. He plans to invest £20,000 of his savings into the new business. He has a number of good business contacts, and is confident that his firm will do well. He thinks that some additional finance will be required in the short term and plans to approach his bank for this.

Mike asks for your assistance in producing a cash budget for his new business for the next six months.

He provides the following information:

- The business, which is to be called 'Art Supplies' will commence in January 20-8.
- Fixed assets costing £8,000 will be bought in early January. These will be paid for immediately and are expected to have a five-year life, at the end of which they will be worthless.
- An initial stock of goods costing £5,000 will be bought and paid for at the beginning of January.
- Monthly purchases of stocks will then be made at a level sufficient to replace forecast sales for that month, ie the goods he expects to sell in January will be replaced by purchases made in January, and so on.
- Forecast monthly sales are:

January	February	March	April	May	June
£3,000	£6,000	£6,000	£10,500	£10,500	£10,500

- The selling price of goods is fixed at the cost price plus 50 per cent; for example, the goods he expects to sell in January for £3,000 will have cost him £2,000 (two-thirds of the selling price), ie his mark-up is 50%.
- To encourage sales, he will allow two months' credit to customers; however, only one month's credit will be received from suppliers of stock (but the initial stock will be paid for immediately).
- Operating expenses of the business, including rent of premises, but excluding depreciation of fixed assets, are estimated at £1,600 per month and are paid for in the month in which they are incurred.
- Mike intends to draw £1,000 each month in cash from the business.

You are asked to prepare a cash budget for the first six months of the business.

solution

Mike Anderson, trading as 'Art Supplies'
Cash budget for the six months ending 30 June 20-8

	Jan	Feb	Mar	Apr	May	Jun
	£	£	£	£	£	£
Receipts						
Capital introduced	20,000					
Debtors	–	–	3,000	6,000	6,000	10,500
Total receipts for month	20,000	–	3,000	6,000	6,000	10,500
Payments						
Fixed assets	8,000					
Stock	5,000					
Creditors	–	2,000	4,000	4,000	7,000	7,000
Operating expenses	1,600	1,600	1,600	1,600	1,600	1,600
Drawings	1,000	1,000	1,000	1,000	1,000	1,000
Total payments for month	15,600	4,600	6,600	6,600	9,600	9,600
Net cash flow	4,400	(4,600)	(3,600)	(600)	(3,600)	900
Add bank balance (overdraft) at beginning of month	–	4,400	(200)	(3,800)	(4,400)	(8,000)
Bank balance (overdraft) at end of month	4,400	(200)	(3,800)	(4,400)	(8,000)	(7,100)

Reminder: No depreciation – a non-cash expense – is shown in the cash budget.

Notes:

- purchases are two-thirds of the sales values (because selling price is cost price plus 50 per cent)
- customers pay two months after sale, ie debtors from January settle in March
- suppliers are paid one month after purchase, ie creditors from January are paid in February

The cash budget shows that there is a need, in the first six months at least, for a bank overdraft. An early approach to the bank needs to be made.

The total net cash outflow for the six month period is £7,100 (ie from a nil opening balance to £7,100 overdraft at 30 June).

advantages of a cash budget

The use of a cash budget enables a business to:

- identify any possible bank overdraft in advance and take steps to minimise the borrowing (so saving interest payable)
- consider rescheduling payments to avoid bank borrowing, eg delay purchase of fixed assets, agreement to pay rises, payment of drawings/dividends
- arrange any possible bank finance well in advance
- identify any possible cash surpluses in advance and take steps to invest the surplus on a short-term basis (so earning interest)

CHAPTER SUMMARY

- A budget is a financial plan for a business, prepared in advance.
- Budgets are used to plan and control the business.
- Budgets – for income or expenditure – are prepared for each section of the business – purchases, sales, production, labour, debtors, creditors, cash
- Budgetary planning is the process of setting the budget for the next period.
- Budgetary control uses the budgets to monitor actual results with budgeted figures.
- Responsibility for budgets is given to managers and supervisors – the budget holders.
- A cash budget sets out the expected cash/bank receipts and payments expected to pass through the bank account, usually on a month-by-month basis.
- A cash budget enables the managers of a business to take action when a surplus of money is shown to be available or when a bank overdraft needs to be arranged.

The next chapter looks at the way in which computers are used to handle accounting transactions and the benefits they bring.

QUESTIONS

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An asterisk (*) after the question number means that the answer is given at the end of this book.

19.1 Classic Furniture is a manufacturer of reproduction antique furniture. It is owned by Helen Sutton as a sole trader business. There are four employees and annual sales turnover is approximately £200,000 per year.

REQUIRED

(a) Explain two benefits of budgetary control to Helen Sutton.

(b) Suggest three budgets which Helen could use in the business to provide an adequate system of budgetary control.

(c) Advise Helen of the relevant factors to consider when implementing budgetary control.

19.2* N Kayali, the assistant accountant at Strudwick Stationers Ltd, has obtained the following information for the seven months ending 30 September 2002. This information is to be used to prepare a cash budget for the four months ending 31 August 2002.

1. Actual sales were £44,000 and £46,000 for March and April 2002 respectively.
2. Total forecast sales at the end of each of the next five months are expected to be:

		2002		
May	June	July	Aug	Sep
£	£	£	£	£
44,000	46,000	42,000	44,000	48,000

80% of each month's total forecast sales are expected to be for cash. The debtors are expected to pay one month in arrears.

3. Purchases are expected to be 70% of the following month's total forecast sales value and are paid for two months in arrears.
4. The following costs are expected to be paid for in the month in which they occur:

   Wages £9,000 per month to 31 July 2002 and £9,500 per month thereafter

   Fixed Costs £3,000 per month

   Variable costs being 10% of each month's total forecast sales
5. The bank balance as at 1 May 2002 was £12,100.

REQUIRED

(a) Prepare a cash budget for each of the four months ending 31 August 2002.

Strudwick Stationers Ltd

Cash Budget for four months ending 31 August 2002

Details	**May** £000	**June** £000	**July** £000	**Aug** £000
....	....	....	....	....
....	....	....	....	....
....	....	....	....	....
....	....	....	....	....
....	....	....	....	....
....	....	....	....	....
....	....	....	....	....
....	....	....	....	....
....	....	....	....	....
....	....	....	....	....
....	....	....	....	....
....	....	....	....	....
....	....	....	....	....

Tutorial note: In the layout provided by this question you need to fill in the details of receipts and payments – use the guidance of the sample layout shown on page 367 to assist you.

(b) N Kayali is unsure of the benefits of producing a cash budget for a four month period. Explain one benefit to Strudwick Stationers Ltd of completing a four month cash budget.

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Assessment and Qualifications Alliance (AQA), 2002

19.3 Sunshine Ltd sells beach buckets and spades.

The forecast information for the six months ending 31 October 2002 is:

	May	June	July	August	September	October
	£000	£000	£000	£000	£000	£000
Sales	16	20	26	28	24	20
Purchases	12	16	18	14	12	10
Overheads	4	8	8	8	8	4

Additional information

1. On average 20% of each month's sales is expected to be for cash. A further 60% will be given one month's credit. The rest will be given two months' credit. All monies should be received when due.
2. The increase in overheads arises from the employment of casual staff. The overheads are paid in the month in which they occur.
3. Suppliers are expected to allow one month's credit.
4. The cash at bank balance as at 1 July 2002 is £7,200 overdrawn.

REQUIRED

(a) Prepare a detailed forecast month by month cash budget for the four months ending 31 October 2002.

Sunshine Ltd
Cash budget for four months ending 31 October 2002

	July £000	Aug £000	Sept £000	Oct £000
Sales – cash				
– 1 month				
– 2 months				
Purchases				
Overheads				
Net inflow/outflow				
Opening balance				
Closing balance				

(b) (i) Assess the cash position of Sunshine Ltd as at 31 October 2002.

(ii) Recommend one way the company could improve its cash position.

Assessment and Qualifications Alliance (AQA), 2001

19.4* Carolanne wishes to open up a launderette. She is applying for an overdraft facility and the bank requires a cash budget for the first four months of business.

The following additional information is available:

1. She intends to start her business with £2,000 in the business bank account.

2. The launderette will open 24 days a month.

3. Sales will be:

Month 1	200 washes
Months 2 and 3	400 washes per month
Month 4	700 washes

   Carolanne charges £2 per wash and £1 for drying. 80% of washes will be dried on the premises.

4. In months 1, 2 and 3, advertising costs will be £30 per month.

5. In month 4, she will employ a part-time assistant at an expected cost of £20 per morning.

6. Washing powder and other washing materials will cost £15 per day.

7. The launderette's fixed costs will be £300 per month.

8. The total cost of the washing machines and dryers will be £18,000. These costs will be paid for in equal monthly instalments over two years.

9. Each month, Carolanne will withdraw for personal use £150 or 10% of the gross monthly revenue, whichever is the greater amount.

REQUIRED

(a) Prepare a cash budget for Carolanne for each of the first four months.

Cash budget for Carolanne for four months

	Month 1 £	Month 2 £	Month 3 £	Month 4 £

(b) Explain two benefits to Carolanne of drawing up this cash budget.

Benefit 1 ....

....

....

Benefit 2 ....

....

....

Assessment and Qualifications Alliance (AQA), 2005

19.5 The accountant of Hawk Ltd is preparing information for the next Directors' meeting. She has calculated that the net profit for the next six months will be: £36,000.

She has also prepared the cash budget for the five months July to November and provided the following information relating to December.

The cash from debtors figure is calculated on the following basis:

> 20% of cash from sales is received in the current month, with customers taking 2% cash discount;

60% is received in the month following the sale;

20% is received two months after the sale is made.

The forecast sales are:

October	November	December
£	£	£
30,000	50,000	60,000

The following payments are forecast for December:

payments to creditors	£12,500
operating expenses	£12,000
purchase of fixed assets	£19,510
repayment of loan	£20,000

REQUIRED

(a) Make the entry for December in the cash budget below.

	Jul £	**Aug** £	**Sep** £	**Oct** £	**Nov** £	**Dec** £
Income						
Cash from debtors	20,000	24,000	28,500	32,500	38,500	
Expenditure						
Payments to creditors	10,000	11,000	14,000	18,000	24,500	
Operating expenses	12,000	12,000	12,000	12,000	12,000	
Purchase of fixed assets		8,500				
Repayment of loan						
	22,000	31,500	26,000	30,000	36,500	
Net cash flow	(2,000)	(7,500)	2,500	2,500	2,000	
Opening balance	980	(1,020)	(8,520)	(6,020)	(3,520)	(1,520)
Closing balance	(1,020)	(8,520)	(6,020)	(3,520)	(1,520)	

(b) Calculate the total net cash outflow for the six months.

(c) Write a memorandum to the Directors explaining three reasons why Hawk Ltd could make a profit but have a bank overdraft.

(d) Explain two benefits of using a spreadsheet* to prepare a cash budget.

* see Chapter 20.

Assessment and Qualifications Alliance (AQA), Specimen Paper for 2009

19.6* You are preparing the cash budget of Wilkinson Limited for the first six months of 20-8. The following budgeted figures are available:

	Sales	*Purchases*	*Wages and salaries*	*Other expenses*
	£	£	£	£
January	65,000	26,500	17,500	15,500
February	70,000	45,000	18,000	20,500
March	72,500	50,000	18,250	19,000
April	85,000	34,500	18,500	18,500
May	65,000	35,500	16,500	20,500
June	107,500	40,500	20,000	22,000

The following additional information is available:

- Sales income is received in the month after sale, and sales for December 20-7 amounted to £57,500
- 'Other expenses' each month includes an allocation of £1,000 for depreciation; all other expenses are paid for in the month in which they are incurred
- Purchases, and wages and salaries are paid for in the month in which they are incurred
- The bank balance at 1 January 20-8 is £2,250

REQUIRED

(a) Prepare a month-by-month cash budget for the first six months of 20-8, using the layout on the next page.

(b) Calculate the total net cash outflow for the six months.

Wilkinson Limited
Cash budget for the six months ending 30 June 20-8

	Jan £	Feb £	Mar £	Apr £	May £	Jun £
Receipts						
....	....	....	....	....	....	....
....	....	....	....	....	....	....
Total receipts for month	....	....	....	....	....	....
Payments						
....	....	....	....	....	....	....
....	....	....	....	....	....	....
....	....	....	....	....	....	....
....	....	....	....	....	....	....
....	....	....	....	....	....	....
Total payments for month	....	....	....	....	....	....
Net cash flow	....	....	....	....	....	....
Add bank balance (overdraft) at beginning of month	....	....	....	....	....	....
Bank balance (overdraft) at end of month	....	....	....	....	....	....

19.7 Jim Smith has recently been made redundant; he has received a redundancy payment and this, together with his accumulated savings, amounts to £10,000. He has decided to set up his own business selling computer stationery and this will commence trading with an initial capital of £10,000 on 1 January. On this date he will buy a van for business use at a cost of £6,000. He has estimated his purchases, sales, and expenses for the next six months as follows:

	Purchases £	*Sales* £	*Expenses* £
January	4,500	1,250	750
February	4,500	3,000	600
March	3,500	4,000	600
April	3,500	4,000	650
May	3,500	4,500	650
June	4,000	6,000	700

He will pay for purchases in the month after purchase; likewise, he expects his customers to pay for sales in the month after sale. All expenses will be paid for in the month they are incurred.

REQUIRED

(a) Jim realises that he may need a bank overdraft before his business becomes established. Prepare a month-by-month cash budget for the first six months of Jim Smith's business, using the layout below.

(b) What is the maximum bank overdraft shown by the cash budget? Suggest two ways in which Jim Smith could amend his business plans in order to avoid the need for a bank overdraft.

Jim Smith
Cash budget for the six months ending 30 June 20--

	Jan	Feb	Mar	Apr	May	Jun
	£	£	£	£	£	£
Receipts						
....	....	....	....	....	....	....
....	....	....	....	....	....	....
Total receipts for month	....	....	....	....	....	....
Payments						
....	....	....	....	....	....	....
....	....	....	....	....	....	....
....	....	....	....	....	....	....
....	....	....	....	....	....	....
....	....	....	....	....	....	....
Total payments for month	....	....	....	....	....	....
Net cash flow	....	....	....	....	....	....
Add bank balance (overdraft) at beginning of month	....	....	....	....	....	....
Bank balance (overdraft) at end of month	....	....	....	....	....	....