I. Budgets

A. The Rationale Behind Developing a Budget:

1. a budget is a projection of the receipts and expenditures of the firm (or subunit of the firm) for a given time period;
2. budgets are essential business tools because they highlight both the planning and control aspects of managerial decision making;
3. the budgeting process forces management to plan ahead and develop contingency plans and as a result provides a useful tool for management to evaluate actual performance against planned performance;
4. the budget provides a basis of evaluating personnel on the basis of meeting budgeted objectives (assuming those personnel have both the responsibility and the authority to make operational decisions;
5. the budget provides a means of coordinating the various subunits of the firm into meeting the objectives of top management and assists management to establish evaluation procedures to motivate personnel to achieve these management objectives;

> It is essential to understand that budgets are based on sales forecasts (or other revenue projections)…so an inaccurate sales forecast can make the budget problematic at best…

B. The MASTER BUDGET summarizes the objectives of each unit and subunit in the organization and should include:

1. objectives of each unit or subunit both operational and financial;
2. projected income and expenses;
3. projected cash flows;
4. projected financial position of each unit at given times during the period;
5. supporting computations and schedules;
6. the master budget includes:
   a. pro forma budgets: (budgeted [target] financial statements
   b. operating budgets: budgeted operational revenues and expenditures (this is the driving force behind the budget)
      1. sales forecast
      2. production budget
      3. direct materials budget
      4. direct labor budget
      5. factory overhead budget
      6. inventory budget
      7. COS budget
      8. sales and administrative expense budget
   c. financial budgets: projected capital expenditures; inflows and outflows of cash

C. The budgeting cycle:

1. planning the performance of the organization and each subunit for a variety of possible scenarios;
2. establish goals or "milestones" through which actual performance can be compared against budgeted performance to enable management to become aware of developing trends and act on them in a timely manner (a control function of the budget);
3. evaluation of the reasons actual performance differs from planned performance;
4. utilizing the information regarding variances to adjust the budget for future periods and help develop a business strategy;

D. **Responsibility Accounting**: a system that places a manager in charge of a responsibility center and then evaluates the actions of the manager in having her/his responsibility center meet budgeted goal.

1. There are four major types of responsibility center:
   a. cost center: responsible for the control of costs only;
   b. revenue center: responsible for the control of revenues only;
   c. profit center: responsible for both costs and revenues (profits)
   d. investment center: responsible for costs, revenues and capital investments
2. Problems with responsibility accounting:
   a. not all factors are controllable by the managers of the responsibility center
      1. uncontrollable factors for each responsibility center must be identified and taken into account in judging managerial performance.

E. Issues in Creating a Budget:

1. *Goal Congruance*: The process of providing an employee evaluation system that is designed to encourage decision makers to make the decisions that are best for the company as a whole.
    a. For example, if a manager is evaluated on keeping costs down, an incentive exists to seek the lowest cost for inputs. If these lower cost inputs cause decreased quality, the overall benefit to the company may be negative when the market rejects the product or will only accept it at a greatly discounted price.
    b. Performance goals established within the budgeting process must be considered reasonable
2. *Acceptance by Participants*
    a. The budget will be problematic unless all members of the organization think it is reasonable
    b. Participative Budgeting: To enhance the probability of "buy-in", both management and employees should participate in formulation of the budget
3. *Incentives for Dishonesty*
    a. Budget Slack/Budget Padding: Because budgets provide a basis to evaluate managers, managers have an incentive to bias budget numbers in order to enhance their evaluation process.
4. *Accuracy of Sales Forecast (Revenue Estimates)*
    a. Because the Sales Budget is based on a specific Sales Forecast, it will only be useful within the parameters of that sales forecast. *If the sales forecast is inaccurate, any **static budget** may not be applicable.*
        1. The solution lies in the creation of a *Flexible Budget* that can be adjusted for fluctuations that may occur with respect to both revenues and costs.

II REVIEW QUESTIONS

1. The financing decisions of management are concerned mainly with obtaining funds for the acquisition of resources. T F

2. In general, the principal benefit to be derived from a modern budgeting system is the significantly increased safety of operations. T F

3. In general, the basic forecast to make in preparing a master budget should be sales volume instead of production volume, if the company has a relatively large manufacturing capacity and operates in a highly competitive industry. T F

4. A usually effective way of forecasting sales is to rely entirely on the predictions of the individual salesmen and sales managers of the organization. T F

5. In the construction of a master budget, the usual first step is the sales forecast and the usual final step is the estimate of production costs and operating expenses. T F

6. Cash budgets should exclude both depreciation expense and the accrual of interest expense. T F

7. The primary purpose of a responsibility accounting system is to determine the attitudes of managers toward their assigned responsibilities. T F

8. MBO is a modern control system that means management before operations. T F

9. Units of materials to purchase would be equal to budgeted materials usage plus the desired ending inventory of materials and minus the beginning inventory of materials. T F

10. Myocene Corporation desires to reduce its $15,000 cash balance by 70% during the budget period. Expected cash inflows and outflows are $82,000 and $103,500, respectively. The amount necessary to borrow during the budget period is $11,000. T F

11. In making a production budget for a given period, one should give consideration to:
    (1) predicted beginning inventories for the period
    (2) desired ending inventories for the period
    (3) both of the above
    (4) none of the above

12. MBO usually means:
    (1) management before operations (3) management by observation
    (2) maximizing budget output (4) none of the above

13. The two factors that have a primary effect on managerial controllability of costs are:
    (1) the amount of cost and the authority of the manager
    (2) the authority of the manager and the time period involved
    (3) the size of the company and the amount of cost
    (4) the type of business and the time period involved

14. Units of finished products to manufacture during a period should be equal to the budgeted sales:
    (1) plus the planned decrease in the inventory
    (2) plus the planned increase in the inventory
    (3) minus the planned increase in the inventory
    (4) none of the above

15. Given: desired ending inventory 2,840 units, budgeted sales 3,600 units, beginning inventory 1,700 units. How many units should be budgeted for purchases?
    (1) 2,460 (2) 5,840 (3) 4,740 (4) none of these

16. A wholesale distributor of lamps marks up its cost of merchandise by 60% of cost to obtain the invoice prices at which sales are made to its dealers. The inventory at the beginning of July is $180,000 and the distributor desires that the July 31 inventory be 40% smaller. Compute the budgeted July purchases if sales are budgeted at $400,000 for July:
(1) $178,000 (2) $322,000 (3) $205,000 (4) some other amount

17. A company plans to reduce its $40,000 balance of cash by 60% during the budget period. Expected cash inflows and outflows are $210,000 and $245,000, respectively. How much should be borrowed during the budget period?
(1) $11,000 (2) $35,000 (3) $75,000 (4) none of these

18. Dawn Company desires to increase its $60,000 cash balance by 20% during the budget period. Projected cash inflows and outflows are, respectively, $424,000 and $431,000. How much must be borrowed during the budget period?
(1) $5,000 (2) $67,000 (3) $55,000 (4) none of these

19. Bueno Company has a $75,000 balance of accounts receivable at the beginning of its budget period. It has budgeted $200,000 sales on account and expects to collect 60% of these in the budget period. What is the ending balance of accounts receivable if all but 20% of the beginning balance is collected during the budget period?
(1) $140,000 (2) $95,000 (3) $135,000 (4) some other balance

20. Weinberger Corporation has a $35,000 balance of accounts receivable at the beginning of its budget period. It has budgeted $160,000 sales on account and expects to collect 70% of these in the budget period. Compute the ending balance of accounts receivable assuming also that all but 10% of the beginning balance is collected during the budget period.
(1) $6,500 (2) $79,500 (3) $89,500 (4) some other balance

SOLUTIONS:

1. T
2. F
3. T
4. F
5. F
6. T
7. F
8. F
9. T
10. T
11. (3)
12. (4)
13. (2)
14. (2)
15. (3)
16. (1)
17. (1)
18. (4)
19. (2)
20. (4)