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**ASSIGNMENTS**

1. What are the four elements of the budgeting cycle?
2. “Strategy plans and budgets are unrelated to one another.” Do you agree? Explain.
3. “Budgeted performance is a better criterion than past performance for judging managers.” Do  
   you agree? Explain.
4. “Production managers and marketing managers are like oil and water. They just don’t mix.” How  
   can a budget assist in reducing battles between these two areas?
5. Does budgeting have any drawbacks? Explain four
6. “Budgets meet the cost-benefit test. They force managers to act differently.” Do you agree? Explain.
7. “The sales forecast is the cornerstone for budgeting.” Why?
8. How can sensitivity analysis be used to increase the benefits of budgeting?
9. What are static budgets and static-budget variances?
10. How can managers develop a flexible budget and why is it useful to do so?
11. How are flexible-budget and sales-volume variances calculated?
12. What is a standard cost and what are its purposes? Why should a company calculate price and efficiency variables?

**Qn. 1.**

Before the four elements of budgeting cycle are elaborated, let’s first have an understanding of what a budget cycle is all about. A budget cycle is the life of a budget from creation or preparation, to evaluation. Most small businesses don't use the term “budget cycle” but they use the process and go through each of its four phases — preparation, approval, execution and evaluation.

The four elements of the budgeting cycle are:-

(a) They compel strategic analysis and planning

(b) They promote coordination and communication among subunits of the company

(c) They provide a framework for judging performance and facilitating learning

(d) They motivate managers and other employees

**Qn. 2.**

I’m in agreement with the statement Strategy, plans, and budgets are interrelated and affect one another as explained under.

Strategy specifies how an organization matches its own capabilities with the opportunities in the marketplace to accomplish its objectives. Strategic analysis underlies both long-run and short-run planning. In turn, these plans lead to the formulation of budgets. Budgets provide feedback to managers about the likely effects of their strategic plans. Managers use this feedback to revise their strategic plans.

**Qn. 3.**

Yes I agree that budgeted performance is a better criterion than past performance for judging managers, because inefficiencies included in past results can be detected and eliminated in budgeting. Also, future conditions may be expected to differ from the past, and these can also be factored into budgets.

**Qn.4.**

Production and marketing traditionally have operated as relatively independent business functions. Budgets can assist in reducing conflicts between these two functions in two ways. Consider a beverage company such as Coca-Cola or Pepsi-Cola:

* Communication. Marketing could share information about seasonal demand with production.
* Coordination. Production could ensure that output is sufficient to meet, for example, high seasonal demand in the summer.

**Qn .9.**

First, what is a static budget? It's a budget that is prepared at the beginning of the year and not changed until it's time to make a new one at the start of the next year. A static budget is just that – static. The numbers do not change for the entire year, regardless of anything that happens in the business environment.

A static budget is a budget that does not change with variations in activity levels. Thus, even if actual sales volume changes significantly from the expectations documented in the static budget, the amounts listed in the budget are not changed. A static budget model is most useful when a company has highly predictable sales and expenses that are not expected to change much through the budgeting period (such as in a monopoly situation). In more fluid environments where operating results could change substantially, a static budget can be a hindrance, since actual results may be compared to a budget that is no longer relevant.

The static budget is used as the basis from which actual results are compared. The resulting variance is called a static budget variance. Static budgets are commonly used as the basis for evaluating sales performance. However, they are not effective for evaluating the performance of cost centers.

A variance is the difference between actual results and expected results. The expected performance of a company is found in the company’s budget for the period. To better illustrate the concept of variances, let’s look at the following scenario:

Suppose you are Chief Executive Officer of a fruit-processing company. The company’s accountant, Kueth, just prepared the Income Statement for the year. The Income Statement showed an operating income of $238,000. Is this a good result or not? A simple way of telling is to compare it with the budget that has been set at the start of year. Suppose studying the budget revealed that the budgeted operating income is $426,400.

|  |  |
| --- | --- |
| Actual Operating Income | $238,000 |
| Static Budget Operating Income | $426,400; planned output level = 12,000 units |

 In this case, the company is said to experience an unfavourable static-budget variance. A static budget refers to a budget developed abound a single planned output level (12,000 units in this case). An unfavourable variance (denoted by “U”) means the actual *operating income (OI)* is lower than that of the budgeted amount.

**Qn .10.**

A flexible budget is a series of budgets prepared for various levels of activities, revenues and expenses. Flexible budgets get modified during the year for actual sales levels, changes in cost of production and virtually any other change in business operating conditions. This flexibility to adapt to change is useful to owners and managers.

A flexible budget can help managers to make more valid comparisons. It is designed to show the expected revenue and the allowed expenditure for the actual number of units produced and sold. Comparing this flexible budget with the actual expenditure and revenue it is possible to distinguish genuine efficiencies.

A brief overview of how a flexible budget is prepared.

Before a flexible budget can be produced, managers must identify which costs are fixed and which are variable. The allowed expenditure on variable costs can then be increased or decreased as the level of activity changes. “Fixed costs” are those costs which will not increase or decrease over a given range of activity. The allowance for these items will therefore remain constant.

For example if Management have identified that the following budgeted costs are fixed:

Direct labor = $8,400

Overheads = $53,000

It is now possible to identify the expected variable cost per unit produced and sold: Now that managers are aware of the fixed costs and the variable costs per unit it is possible to ‘flex’ the original budget to produce a budget cost allowance for 1,000 units produced and sold.

The budget cost allowance for each item is calculated as follows:

Cost allowance = budgeted fixed cost + (number of units produced and sold x variable cost per unit)

 For the costs which are wholly fixed or wholly variable the calculation of the budget cost allowance is fairly straightforward. The remaining costs are semi-variable, which means that they are partly fixed and partly variable.

The budget cost allowance for direct labor is calculated as follows:

Cost allowance for direct labor = $8,400 + (1,000 units x $4) = $12,400

The budgeted sales price per unit is $120,000 / 1,200 = $100 per unit.

 If it is assumed that sales revenues follow a linear variable pattern (because the sales price remains constant) the full flexible budget can now be produced.

To make sure that you followed it, let’s do further example. Following the example of the calculation of the budget cost allowance for direct labor, calculate a revised budget cost allowance for all costs for an activity of 1,000 units and produce a revised variance statement for April.

Firstly, we need to compute the cost allowance for the overhead.

Cost allowance for overhead = $53,000 + (1,000 units x $7) = $60,000

Therefore managers can prepare a flexible budget by:-

* Separating the initial budget into fixed and variable expenses. Fixed expenses include things like the rent for your business space and marketing costs, which do not change even if production does. Variable expenses include things such as material costs and hours of labor, which do change with production level.
* Dividing the initial budget for variable expenses by the estimated production to get your initial budget per unit produced.
* Determining your actual fixed and variable expenses for the production period based on your expense records.
* Dividing your actual variable expenses by your actual production to get the actual variable expense per unit.
* Dividing your expected revenue from your initial budget by the budgeted production to get your expected revenue per unit. Divide your actual revenue by your actual production to get your actual revenue per unit.
* Comparing your initially budgeted and actual fixed costs, variable costs per unit and revenue per unit. This will allow you to clearly see where you were under- or over-budget and determine what caused you to exceed or fall below your expected gross profit.

And it’s useful to prepare a flexible budget for the following reasons:-

* **Take Advantage of Opportunities:** Variable expenses in flexible budgets are defined as percentages of sales. For example, if sales were to increase dramatically, flexible budgets would get adjusted to increase spending on marketing to take even more advantage of unexpected increases in revenues.

Similarly, while a static budget would limit hiring more employees, a flexible budget would adapt to the need for more staff to meet increased demand by increasing the budget for payroll expenses.

* **Adjust for Changing Costs and Profit Margins:** With static budgets, costs of operations and product profit margins are set at the start of the year, based on historical data. Unfortunately, real life doesn't let everything stay the same. Flexible budgets can handle these changes.

Suppose material costs for a product suddenly increase during the year, making this item unprofitable. A flexible budget would spot this variance, and management could take corrective actions. It might be a price increase or an effort to find cost savings in manufacturing expenses.

* **Better Cost Controls:** Flexible budgets react more quickly to adverse conditions. Suppose the budget was set up with the expectation that sales would be $200,000 per month and labor cost was budgeted at $50,000 per month, or 25 percent of sales.

If sales declined to $150,000 per month, then labor cost should be reduced to $37,500 (25 percent of $150,000). A static budget would not adjust to the decline in revenues and would keep labor costs at the original level.

* **Updated With Current Data:** Revenues and expenses are constantly adjusted in flexible budgets for current operating conditions. New environmental regulations might increase the costs of production and could require the purchase of different types of machines. Weather conditions could increase shipping costs and result in delayed shipments to customers.

With flexible budgets, managers are constantly updating their projections and cost controls with current information. The most significant advantage of flexible budgets over static ones is the ability to adapt to changes in the real world. Nothing ever stays the same, and management has the responsibility to respond to unanticipated adverse conditions and to take advantage of unexpected opportunities.

**Question .11.**

A flexible budget calculates budgeted revenues and costs based on actual output (10,000 units in this case). We see that there are two factors that led to the unfavorable variance: (1) that production and sales volume were not as high as expected (sales-volume variance), (2) other factors (flexible-budget variance).

To compute the value of the flexible budget, multiply the variable cost per unit by the actual production volume. Here, the figure indicates that the variable costs of producing 125,000 should total $162,500 (125,000 units x $1.30).

The difference between the budgeted quantity of units sold and the actual quantity of units sold. This figure is multiplied by the profit per unit (margin). For example, if a company sold 100 more units than it expected at a profit per unit of $3, its sales volume variance is $300 (100 units x $3/unit).

Sales volume variance: The difference between the budgeted quantity of units sold and the actual quantity of units sold. This figure is multiplied by the profit per unit (margin). When calculating the sales volume variance, the profit per unit is used, not the selling price.

Sales Volume Variance is the measure of change in profit *or contribution* as a result of the difference between actual and budgeted sales quantity.

**Formula**

Sales Volume Variance *(where absorption costing is used)*:

|  |  |  |  |
| --- | --- | --- | --- |
| = | (Actual Unit Sold - Budgeted Unit Sales) | x | Standard Profit Per Unit |

Sales Volume Variance *(where marginal costing is used)*:

|  |  |  |  |
| --- | --- | --- | --- |
| = | (Actual Unit Sold - Budgeted Unit Sales) | x | Standard Contribution Per Unit |

Explanation

Sales Volume Variance quantifies the effect of a change in the level of sales on the profit or contribution over the period.

Sales volume variance differs from other volume based variances such as material usage variance and labor efficiency variance in that it calculates not just the variance in sales revenue as a result of the change in activity but it quantifies the overall change in the profit or contribution.

The nature of the sales volume variance helps in forming a more meaningful analysis of other variances in the preparation of the operating statement. For example, the material usage variance needs to take into account only the difference between the *actual consumption of material* and the *standard consumption of material for the actual number of units* sold since the **sales volume variance** already takes into account the variation in material cost caused by the difference between budgeted and actual sales volume.

Sales volume variance should be calculated using the standard **profit** per unit in case of absorption costing whereas in case of marginal costing system, standard **contribution** per unit is to be applied.

**Qn .12.**

Standard cost: An estimated or predetermined cost of performing an operation or producing a good or service, under normal conditions.

Standard costs are used as target costs (or basis for comparison with the actual costs), and are developed from historical data analysis or from time and motion studies. They almost always vary from actual costs, because every situation has its share of unpredictable factors. Also called normal cost.

In accounting, a standard costing system is a tool for planning budgets, managing and controlling costs, and evaluating cost management performance. A standard costing system involves estimating the required costs of a production process.

Leni! Standard costing is one of important technique of controlling the cost of company in which standard cost is determined for each department and each element of cost. After this, we use variance analysis for seeing whether our cost is less than our standard cost. If our actual cost is less than our standard cost, we have successful in our mission. So, all these things include in standard costing. Following points will explain the purposes of standard costing more deeply:

* **For Fixing the Responsibility:** If there is unfavourable variance after variance analysis in standard costing, we will fix the responsible of our employees. Suppose, if the standard cost of labor is less and actual cost of labor is more. It means, we have paid more to employees. This is our big loss. Who is responsible to pay salary to employees? That person has to give answer for this.
* **Management by Exceptions:** We can use management by exceptions easily with standard costing. Management by exception means to concentrate big projects of company instead of doing small and small supervision. In standard costing, we have made standard of our cost. Now, feel relax and happen what is happening and only check and compare results relating to material, labor and overhead cost.
* **Study of Time and Speed:** For calculating standard cost, we have to study of time and speed. When we study, we get knowledge of new ways to increase our speed at lowest time. So, standard costing promotes innovation.
* **Helpful in Production Policy:** Standard costing's one purpose is to help in production policy. We make only good standards if we know complete report of variance. That report can be available in standard costing technique.
* **Helpful in Planning Budget:** Planning budget may be also easy in standard costing.
* **Increase in Efficiency:** In standard costing technique, every employee will become alert. Because he knows that if he will not bring performance, company may demote him. With this, efficiency of employee will increase.
* **Easy to Evaluate Stock:** To evaluate stock is very easy in this technique.
* **Easy to Delegate Powers:** Delegation of powers is very easy in this technique because I will promote to that employee whose performance will be the best. How can I measure his performance? Just check the variance. Suppose, his duty is to buy material. If material cost variance shows positive variance and after investigation, we found that our actual material cost is very less due to the good buying strategy of that employee. We will make him the manager of purchase department by delegate our powers.

And a company should calculate price and efficiency variables because it helps to understand why fluctuations happen and what can / should be done to reduce the adverse variance. This eventually helps in better budgeting activity.

More so it is extremely important as a means to visualise and understand the data being considered.

And finally it’s important to calculate price and efficiency variables because it acts as a measure of how dispersed or spread out the set is, something that the “average” (mean or median) is not designed to do.

**Qn .5.**

Yes budgeting has drawbacks. But before we look at the drawbacks of budgeting, we need to understand the term ‘‘budget’’ and ‘‘budgeting’’.

The budget is the plan which intends to figure out expected operations revenue and expenses of an organization for a future time period. In other words for a business entity budgeting is the process of preparing detailed statement of financial results that are projected for a certain period of time.  Budgeting is to estimate the future while taking the management inputs considering internal and external factors of the organization.

The drawbacks of budgeting are:-

* Promotes gamesmanship
* More money given each year regardless whether it is needed or not
* Cost will be too high
* Incremental budgeting encourages laziness
* Incremental budgeting encourages inefficiency, waste and slack
* It assumes that the 3Es are already in place
* lack of flexibility
* There is a mismatching of products or services.

And four of the above drawbacks are explained as under:

* **Incremental budgeting encourages inefficiency, waste and slack:** not taking time to evaluate things in the light of current happenings increases the chance of continuing with and encouraging inefficiencies in processes. Managers will then use the opportunity of not being vetted to pad the budget as much as they could.
* **More money given each year regardless whether it is needed or not**: spend it or lose it attitude is encouraged by this method of budgeting system although it is common practice for more money to be given to an underperforming department in the government. The police for example get more money when the crime rates are high.
* **Cost will be too high**: an organization can be running at a loss simply due to the type of budgeting system in use. This is because incremental of the fact that managers could unnecessarily pad the budget thereby using £10,000.00 for a project that easily be completed for far less.
* **It assumes that the 3Es are already in place**: simply increasing last year’s budget by some percentages is indirectly endorsing last year’s performance. The 3E principles states that resources must be used in such a way that Economy, Efficiency and Effectiveness would be achieved.

**Qn .7.**

Sales forecasting is the process of estimating future sales. Accurate sales forecasts enable companies to make informed business decisions and predict short-term and long-term performance. Companies can base their forecasts on past sales data, industry-wide comparisons, and economic trends.

A firm covers its expenses through sales. Sales forecast is an extension of past and/or current sales in the future period (e.g. week, month, year, etc.) Budgets are forecasted expenses.   
Since expenses should not exceed sales for achieving profit sales forecast serves as a cornerstone for budgeting.

The sales forecast is typically the cornerstone for budgeting, because production and inventory levels generally depend on the forecasted level of sales.

Sales forecasting serves as the starting point for all activities of the firm and gives direction to all activities.

It is the starting point in budgeting because sales impacts/ drives virtually every aspect of a firm's activities because sales will determine revenues and direct costs.

Sales forecasting helps the organization to make decision on which produces are to be dropped, which ones are to be continued, which ones need modification and which ones are to be added. It enables the organization to realize it exact position in the market which in turn facilitate optimum utilization of resources, achieve optimum gains as a result of marketing opportunities, and ensure optimum penetration of markets.

Furthermore, sales forecasting constitute the backbone of marketing. It not only provides for the numbers in regard to sales, but also critical clues regarding customers, needs, preferences and tastes. Only with appropriate sales forecasting can the organization meaningfully manage formulation of an effective marketing strategy and take control of its marketing planning in totality.

6.

**Qn. 6.**

Yes I agree that budgeted performance is a better criterion than past performance for judging managers because inefficiencies included in past results can be detected and eliminated in budgeting.

**Qn. 8.**

Sensitivity analysis adds an extra dimension to budgeting. It enables managers to examine how amounts change with changes in the underlying assumptions budgeted.

A sensitivity analysis determines how different values of an independent variable affect a particular dependent variable under a given set of assumptions. In other words, sensitivity analyses study how various sources of uncertainty in a mathematical model contribute to the model's overall uncertainty. This technique is used within specific boundaries that depend on one or more input variables.

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