

41 Setting budgets

What is a budget?

The control of a business becomes more difficult the larger it is. A new, small business setting up may be run informally. The owner is the manager, who will know everyone, be aware of what is going on and will make all decisions. In medium sized and larger firms, work and responsibility are delegated, which makes informal control impractical. To improve control, budgeting has been developed. This forces others to be accountable for their decisions.

A BUDGET is a plan which is agreed in advance. It must be a plan and not a forecast. A forecast is a prediction of what might happen in the future, whereas a budget is a planned outcome which the firm hopes to achieve. A budget will show the money needed for spending and how this might be financed. Budgets are based on the objectives of businesses. They force managers to think ahead and improve co-ordination. Most budgets are set for twelve months to coincide with the accounting period, but there are exceptions. Research and Development budgets, for example, may cover several years.

Information contained in a budget may include revenue, sales, expenses, profit, personnel, cash and capital expenditure. In fact, budgets can include any business variable (known as a budget factor) which can be given a value. One well known budget is 'The Budget'. The Chancellor of the Exchequer prepares a budget for a particular period. It will take into account the government's spending plans and how these plans will be financed by taxes and other sources of funds.

The reasons for setting budgets

There is a number of reasons why a business sets budgets.

Control and monitoring Budgeting helps control a business. It does this by setting objectives and targets. These are then translated into budgets for, say, the coming year. Success by the business and the workforce in achieving those targets can be found by comparing the actual results with the budget. The reasons for failing to achieve the budget can then be analysed and appropriate action taken.

Planning Budgeting forces businesses to think ahead. Without budgeting, people might work on a day-to-day basis, only dealing with opportunities and problems as they arise. Budgeting, however, plans for the future. It anticipates problems and their solutions.

Co-ordination As a business grows in size its organisation becomes more complicated. There may be different departments or different production and administrative sites. A multinational company will have workers spread across the world. Budgeting is

one way of co-ordinating the activities of areas of the business.

Communication Planning allows the objectives of the business to be communicated to its employees. By keeping to a budget, employees have a clear framework within which to operate. So budgeting removes an element of uncertainty within decision making throughout the business.

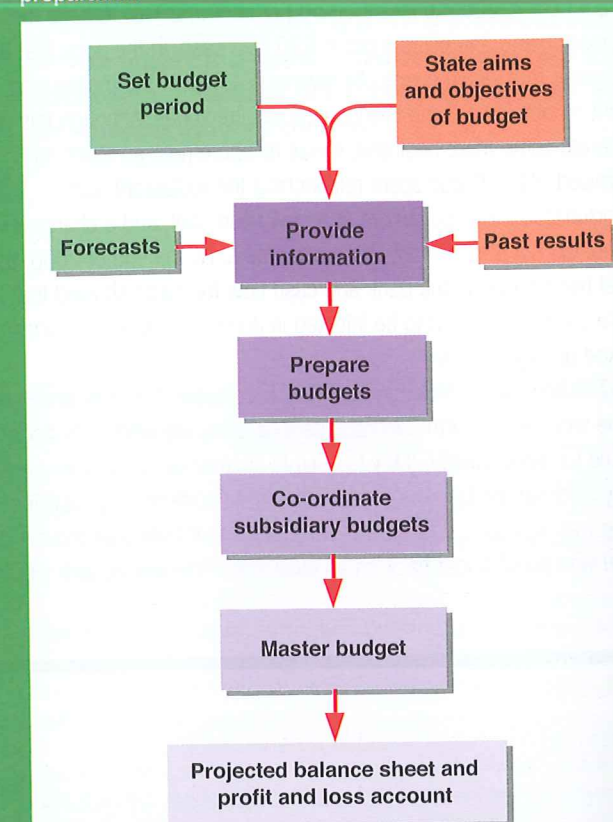
Efficiency In medium sized or larger businesses it may be difficult for one person to make every decision. Budgeting gives financial control to those workers who are best able to make decisions in the business.

Motivation Budgeting should act as a motivator to employees. It provides workers with targets and standards. Improving on the budget position is an indication of success. Fear of failing to reach budgeted targets may make workers work harder.

The preparation of budgets

The way in which a budget might be prepared is shown in Figure 1. It is a step-by-step process.

Figure 1: A summary of the stages involved in budget preparation



Setting budgets

Table 1: Planned sales figures for Emerald Artwork

	Feb	Mar	Apr	May
AD23	100	100	100	100
AD24	50	80	80	100
AE12	40	50	40	50
AE13	30	30	50	50

- Decide on a budget period and state the objectives and targets which are to be achieved. The budget period may vary according to the type of budget. One month or one year is usual. Targets for performance, market share, quality (provided it can be quantified) and productivity are all examples.
- Obtain information upon which to base the budget. A new business setting up will not be able to base its budgets on its own historical information. So it will need to estimate future figures. It may do this from market research. Some business variables are easier to estimate than others. It may be easier to quantify future costs than future sales, for example. This is because sales levels are subject to so many external factors. Once the business has traded for a period, budgets can be based on past figures.
- Prepare budgets. Two important budgets are the sales budget and the production budget. These budgets are related and affect all other budgets. For example, sales targets can only be met if there is productive capacity. Also, a firm would be unlikely to continue production if it could not sell its products. The sales budget will contain monthly sales estimates, expressed in terms of quantities per product, perhaps, and the price charged. From the sales budget, and with knowledge of stock levels, the production budget can be determined. This will show the required raw materials, labour hours and machine hours. At this stage the business should know whether or not it has the capacity to meet the sales targets. If it is not possible, then it may be necessary to adjust the sales budget.
- Draw up subsidiary operating budgets. These are detailed budgets usually prepared by medium sized and larger businesses. Budgets can be broken down, so that each person in the hierarchy can be given some responsibility for a section of the budget.
- The MASTER BUDGET is a summary statement of all budgets. For example, it shows the estimated income, anticipated expenditure, and, thus, the budgeted profit for the period. The cash budget can be prepared when all other budgets are complete. This budget is particularly useful since it shows the monthly flows of cash into and out of the business. It will help to show

Table 2: A sales revenue (income) budget for Emerald Artwork

	(£)			
	Feb	Mar	Apr	May
AD23	1,200 (12 x 100)	1,200 (12 x 100)	1,200 (12 x 100)	1,200 (12 x 100)
AD24	1,000 (20 x 50)	1,600 (20 x 80)	1,600 (20 x 80)	2,000 (20 x 100)
AE12	1,000 (25 x 40)	1,250 (25 x 50)	1,000 (25 x 40)	1,250 (25 x 50)
AE13	900 (30 x 30)	900 (30 x 30)	1,500 (30 x 50)	1,500 (30 x 50)
Total	4,100	4,950	5,300	5,950

whether future cash flow problems might occur.

- Prepare the projected balance sheet and profit and loss of the business. These show the financial position that will result from the firm's budgets.

Income or sales revenue budget

An INCOME or SALES REVENUE BUDGET shows the planned income or revenue for a period of time. Emerald Artwork produces four products, AD23, AD24, AE12 and AE13. They sell for £12, £20, £25 and £30 respectively. The planned sales levels for a four month period are shown in Table 1.

The budget is prepared by showing the planned income or sales revenue in each month. This is calculated by multiplying the predicted sales levels by the prices. The sales revenue budget is shown in Table 2.

Table 3: A production budget for Emerald Artwork covering production of all 4 products

	(£)			
	FEB	MAR	APR	MAY
Cost of materials (£3 per unit)	660 (3 x 220)	780 (3 x 260)	810 (3 x 270)	900 (3 x 300)
Direct labour costs (£4 per unit)	880 (4 x 220)	1,040 (4 x 260)	1,080 (4 x 270)	1,200 (4 x 300)
Indirect labour costs (£2 per unit)	440 (2 x 220)	520 (2 x 260)	540 (2 x 270)	600 (2 x 300)
Production Overheads (10% of direct & indirect costs)	1,320 x 10% = 132	1,560 x 10% = 156	1,620 x 10% = 162	1,800 x 10% = 180
Total	2,112	2,496	2,592	2,880

Table 4: An expenditure budget for Emerald Artwork

	(£)			
	Feb	Mar	Apr	May
Materials	660	780	810	900
Direct labour	880	1,040	1,080	1,200
Indirect labour	440	520	540	600
Production overheads	132	156	162	180
General overheads	300	600	200	700
Capital expenditure	2,000	0	200	1,700
Total expenditure	4,412	3,096	2,992	5,280

Table 5: Profit budget for Emerald Artwork

	(£)			
	Feb	Mar	Apr	May
Income (sales revenue)	4,100	4,950	5,300	5,950
Expenditure	2,412	3,096	2,792	3,580
Profit	1,688	1,854	2,508	2,370

Production budget

Once Emerald Artwork has produced a sales budget, it is possible to calculate its production budget. The example in Table 3

Question 1.

Hannah Ngilo and David Saunders run Penzance Motor Services. The business generates revenue in a number of ways. It sells petrol, a limited range of grocery and confectionery items, car accessories and a few second-hand cars. The garage also carries out servicing, motor repairs and MOT testing. An income budget for a six month period is shown in Table 6.

- Complete the income budget for Penzance Motor Services by calculating the total monthly income.
- Hannah and David set sales targets for each source of income. What role will setting budgets play when setting such targets?
- Explain how the information in this budget might be used in a profit budget.

Table 6: Income budget for Penzance Motor Services

	(£)					
	Jan	Feb	Mar	Apr	May	Jun
Petrol sales	3,400	3,500	3,400	3,600	4,000	4,500
Grocery sales	650	650	700	700	750	800
Car accessories	450	500	500	550	550	600
Car sales	1,000	1,500	2,000	4,000	5,000	6,000
Servicing and repairs	4,300	4,800	5,000	4,500	4,000	3,500
MOTs	400	500	450	550	600	500
Total income						

assumes stock levels stay the same throughout the four month period. The figures are based on expected sales in Table 1.

Expenditure budget

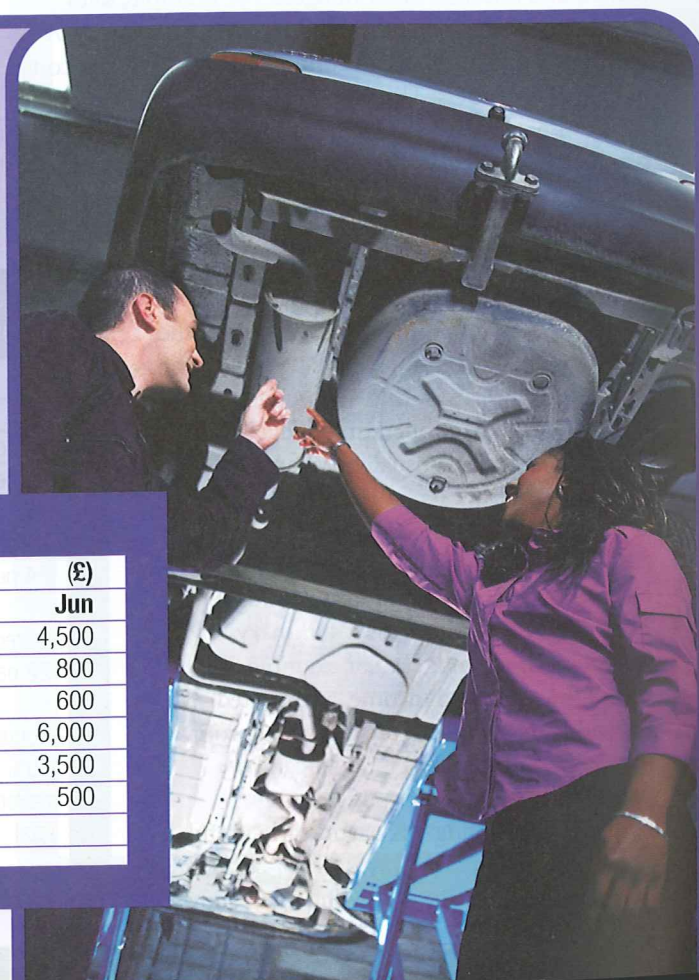
An EXPENDITURE or TOTAL COST BUDGET shows how much money a business is expected to spend for a period of time. It is based on the production budget. Expenditure might include raw materials, labour, production overheads, general overheads and capital expenditure such as new machinery. An expenditure budget is shown for Emerald Artwork in Table 4. It is based on the production budget but includes all other business expenditure for the four month period.

Profit budget

A PROFIT BUDGET shows the amount of profit a business is expected to make over a period. It contains information on all income generated by the business and all expenditure. However, the profit budget would not include capital expenditure. A profit budget for Emerald Artwork is shown in Table 5. Note that capital expenditure has been excluded. In the profit budget, expenditure is subtracted from income to get the monthly profit.

Problems of setting budgets

Businesses may sometimes find that there are problems when setting budgets.



Question 2.

Melanie Croft runs the Motherwell Leisure Centre, a private leisure facility for residents in the Motherwell and Hamilton areas of Scotland. The centre has about 900 members and offers a range of facilities. In order to keep control of costs Melanie sets expenditure budgets every six months for the various departments within the complex. An expenditure budget for the first six months of 2007 is shown in Table 7.

- Complete the expenditure budget shown in Table 7 and calculate the total expenditure for the sixth month period.
- What might account for the pattern of expenditure for the café bar over the time period?
- Explain how using an expenditure budget could help Melanie control costs in the business.

Table 7: Expenditure budget for the Motherwell Leisure Centre – January to June 2007

	(£)					
	Jan	Feb	Mar	Apr	May	Jun
Sports Hall	1,400	1,600	1,700	1,700	1,500	1,300
Swimming pool	2,300	2,400	2,400	2,500	3,000	3,500
Games room	600	700	600	500	400	200
Fitness centre	3,200	3,500	3,600	3,600	3,400	3,200
Outdoor activities	500	400	500	600	800	1,000
Massage & beauty treatments	5,300	5,300	6,000	6,000	7,000	7,000
Administration	2,000	2,000	2,000	2,000	2,000	2,000
Café bar	3,200	3,500	3,700	4,000	5,000	7,000
Total expenditure						

Using planned figures Problems tend to arise because figures in budgets are not actual figures. Planned figures may be inaccurate. The most important data in the preparation of nearly all budgets is sales data. If sales data are inaccurate, many of the firm's budgets will be inexact. The accuracy of sales data might be improved if market research is used. However, it may be difficult to estimate sales of new products for a future period.

Collecting information The setting of budgets in some businesses may require a great deal of co-ordination. This is because different parts of the business may provide information for budgets. Some medium sized and larger businesses appoint a budget officer. This person is responsible for collecting data and opinions, keeping managers to the budget timetable and carrying out budgetary administration.

Conflict The setting of budgets may lead to conflict between staff. For example, a business may only have limited funds. One person may want to spend this on marketing, but another may feel that new machinery is needed.

Cost The time spent setting budgets could have been spent on

other tasks. This is very important for a small, new business with limited resources.

Over-ambitious objectives Sometimes businesses set over-ambitious objectives. When this happens, the budgeting process is pointless because budgets are being drawn up for targets which are unachievable. The budget then ceases to become a benchmark with which to compare the outcome.

External influences In some industries, it is difficult to plan ahead because of large and unpredictable changes in the external environment. In farming, for instance, there can be variations in price from year to year and the weather can have large effects on output. This doesn't mean that businesses in such industries should not draw up budgets. However, it can be difficult to analyse outcomes against the budget. It may be unclear if external influences or the way in which a business is run have affected whether a budget is achieved or not.

KEYTERMS

Budget – a quantitative economic plan prepared and agreed in advance.

Income or sales revenue budget – shows the planned income or revenue for a period of time.

Expenditure or total cost budget – shows how much money a business is expected to spend for a period of time

Profit budget – shows the amount of profit a business is expected to make over a period.

Master budget – a summary statement which brings together information from budgets.

KNOWLEDGE

- How might a budget improve employee accountability?
- Why is the sales budget such an important budget?
- How might budgets motivate staff?
- State examples of three types of budget.
- Why might a business manipulate a budget?
- What costs are incurred when setting budgets?