CHAPTER 7: PLANNING FOR PROFIT AND COST CONTROL

Learning Objectives

1. Three Levels of Planning
2. Describe the master budget and explain its benefits
3. Describe the advantages of budgets
4. Prepare the operating budget and its supporting schedules
5. Use computer-based financial planning models for sensitivity analysis
6. Recognize the Human Aspects of Budgeting

Three Levels of Planning

Learning Objective 1

Three Levels of Planning

1. **Strategic planning** involves making long-term decisions such as defining the scope of the business, determining which products to develop or discontinue and identifying the most profitable markets.

2. **Capital budgeting** focuses on intermediate-range planning and involves decisions such as whether to buy or lease equipment, whether to stimulate sales, or whether to increase company assets.

3. **The Operations budget** describes short-term objectives in specific amounts of sales targets, production goals, and financing plans.

Describe the Master Budget and Explain Its Benefits

Learning Objective 2

Budget Defined

- The quantitative expression of a proposed plan of action by management for a specified period, and
- An aid to coordinating what needs to be done to implement that plan
- May include both financial and nonfinancial data

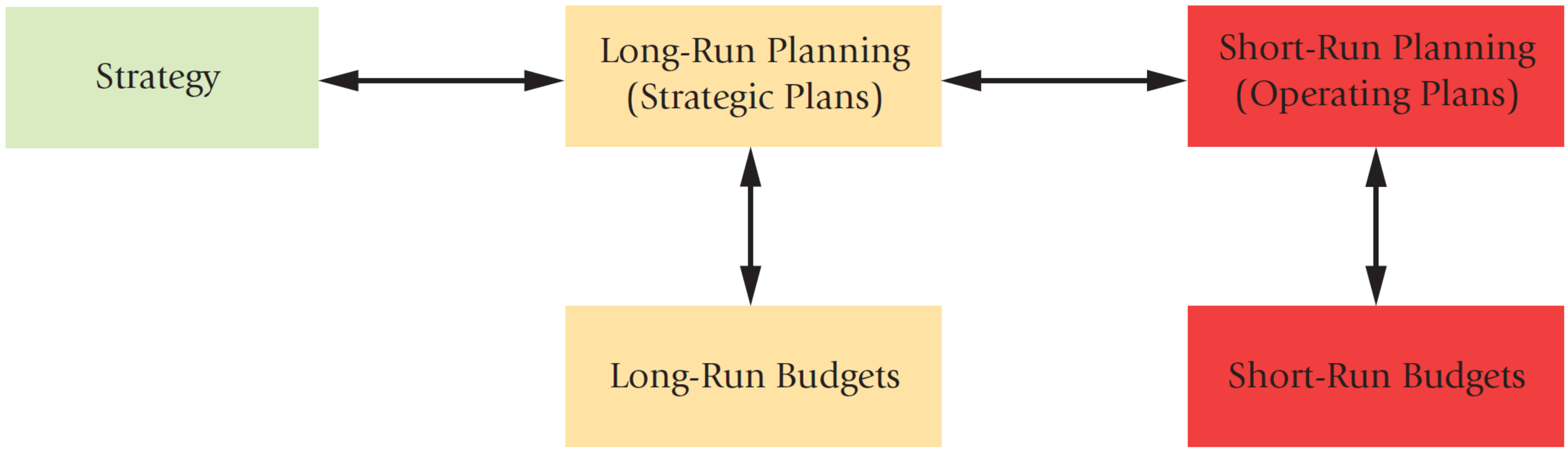
Financial Budget

- It quantifies management's expectations regarding income, cash flows, and financial position
- Managers derive financial budgets using supporting information from nonfinancial budgets

Budget Integrated with Strategy

- Strategy specifies how an organization matches its own capabilities with the opportunities in the marketplace to accomplish its objectives
- Strategic plans are expressed through long-run budgets, and operating plans are expressed through short-run budgets
- Budgets help managers assess strategic risks and opportunities by providing them with feedback about the likely effects of their strategies and plans

Strategy, Planning, and Budgets



Budgeting Cycle

- Before the start of the fiscal year, managers at all levels take into account past performance, market feedback, and anticipated future changes to initiate plans for the next period
- At the beginning of the year, senior managers give subordinate managers a frame of reference, a set of specific financial or nonfinancial expectations against which they will compare actual results

Budgeting Cycle

- During the course of the year, management accountants help managers investigate variations from plans, such as an unexpected decline in sales
- If necessary, corrective action follows

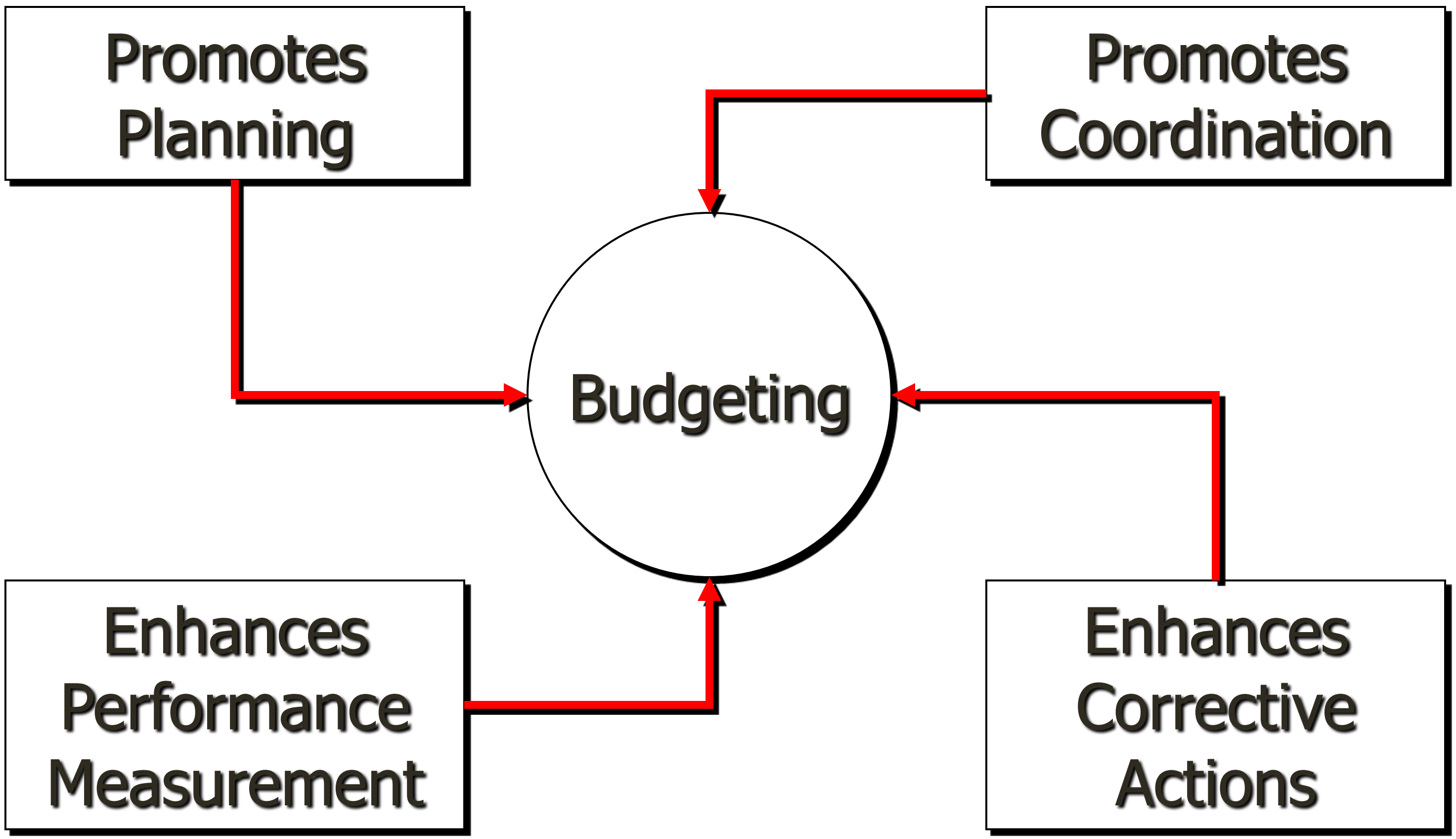
Master Budget

- It expresses management's operating and financial plans for a specified period, usually a fiscal year
- It includes a set of budgeted financial statements
- Under a master budget,
  - Operating decisions deal with how to best use the limited resources of an organization
  - Financing decisions deal with how to obtain the funds to acquire those resources
- Also known as pro forma statements

Describe the Advantages of Budgets

Learning Objective 3

Advantages of Budgeting



Advantages of Budgets

- Promotes coordination and communication among subunits within the company
- Provides a framework for judging performance
- Motivates managers and other employees
- **Coordination** is meshing and balancing all aspects of production or service and all departments in a company in the best way for the company to meet its goals
- Communication is making sure all employees understand those goals

Framework for Judging Performance and Facilitating Learning

- Budgets enable a company’s managers to measure actual performance against predicted performance
- Budgets can overcome two limitations of using past performance as a basis for judging actual results:
  - Past miscues and substandard performance
  - Future conditions can be expected to differ from the past

Motivate Managers and Other Employees

- Employee performance improves when they receive a challenging budget because employees view falling short of budgeted numbers as a failure
- Many executives like to set demanding but achievable goals for their subordinate managers and employees

Challenges in Administering Budgets

- The budgeting process should involve all levels of management
- The budgeting process is time-consuming
- To gain the benefits of budgeting, management at all levels of a company should understand and support the budget and all aspects of the management control system
- Budgets should not be administered rigidly

Prepare the Operating Budget and Its Supporting Schedules

Learning Objective 4

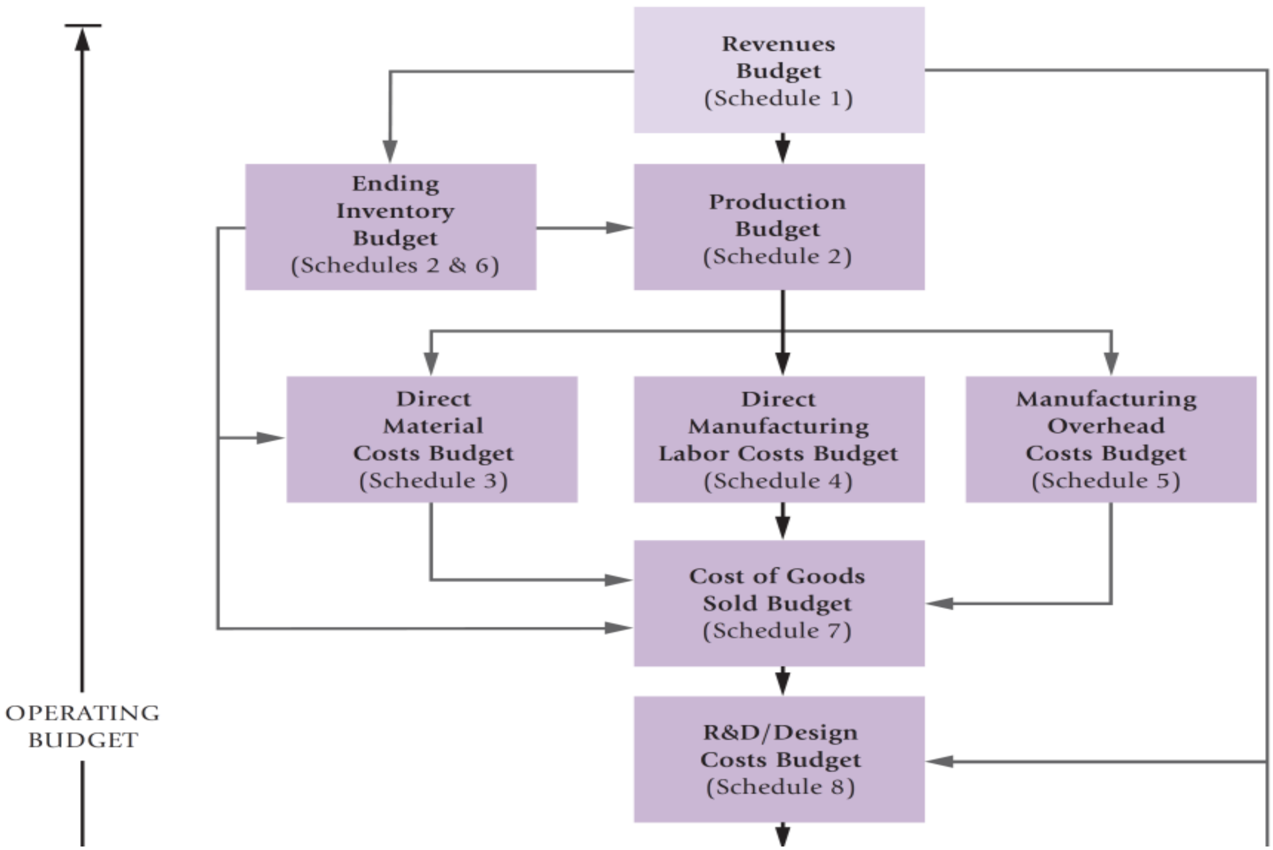
Time Coverage of Budgets

- Budgets are typically developed for a set period, such as a month, quarter, or year, which can be then broken into sub-periods
- The budgeted data for a year are frequently revised as the year goes on

Rolling Budget

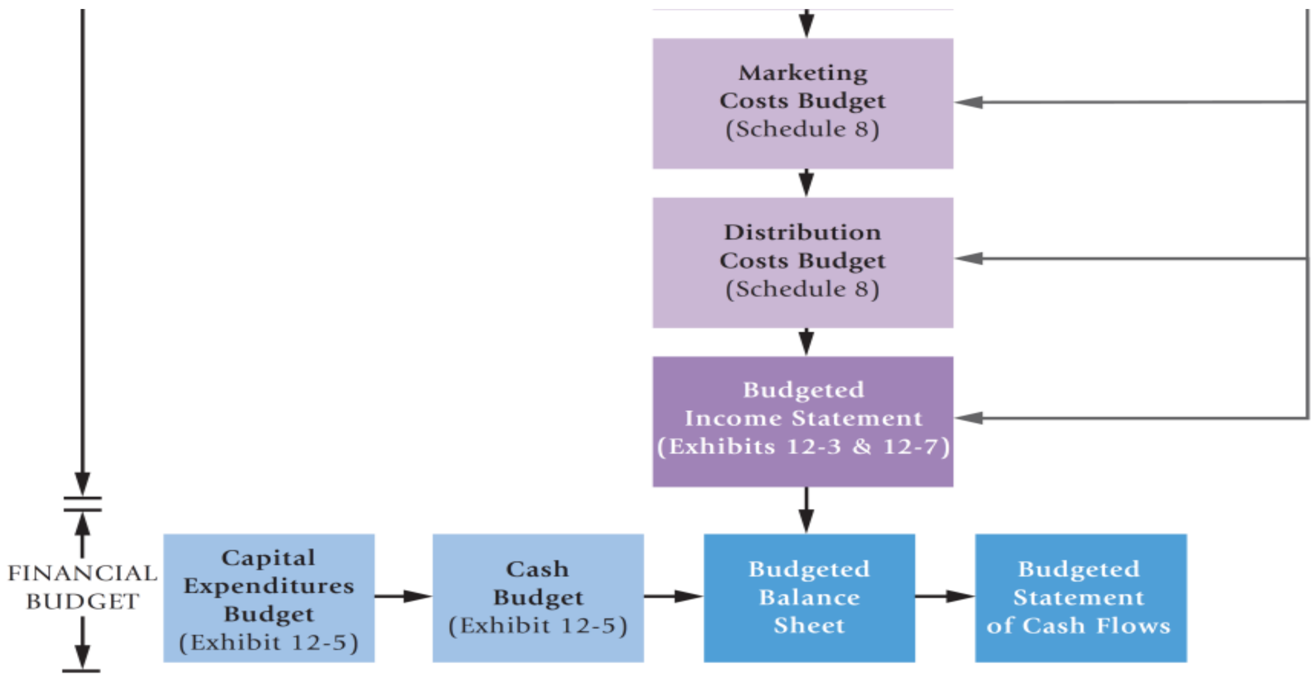
- Also called a continuous budget or rolling forecast
- Is a budget that is always available for a specified future period

Overview of the Master Budget



Continued….

Overview of the Master Budget (Continued)



Continued….

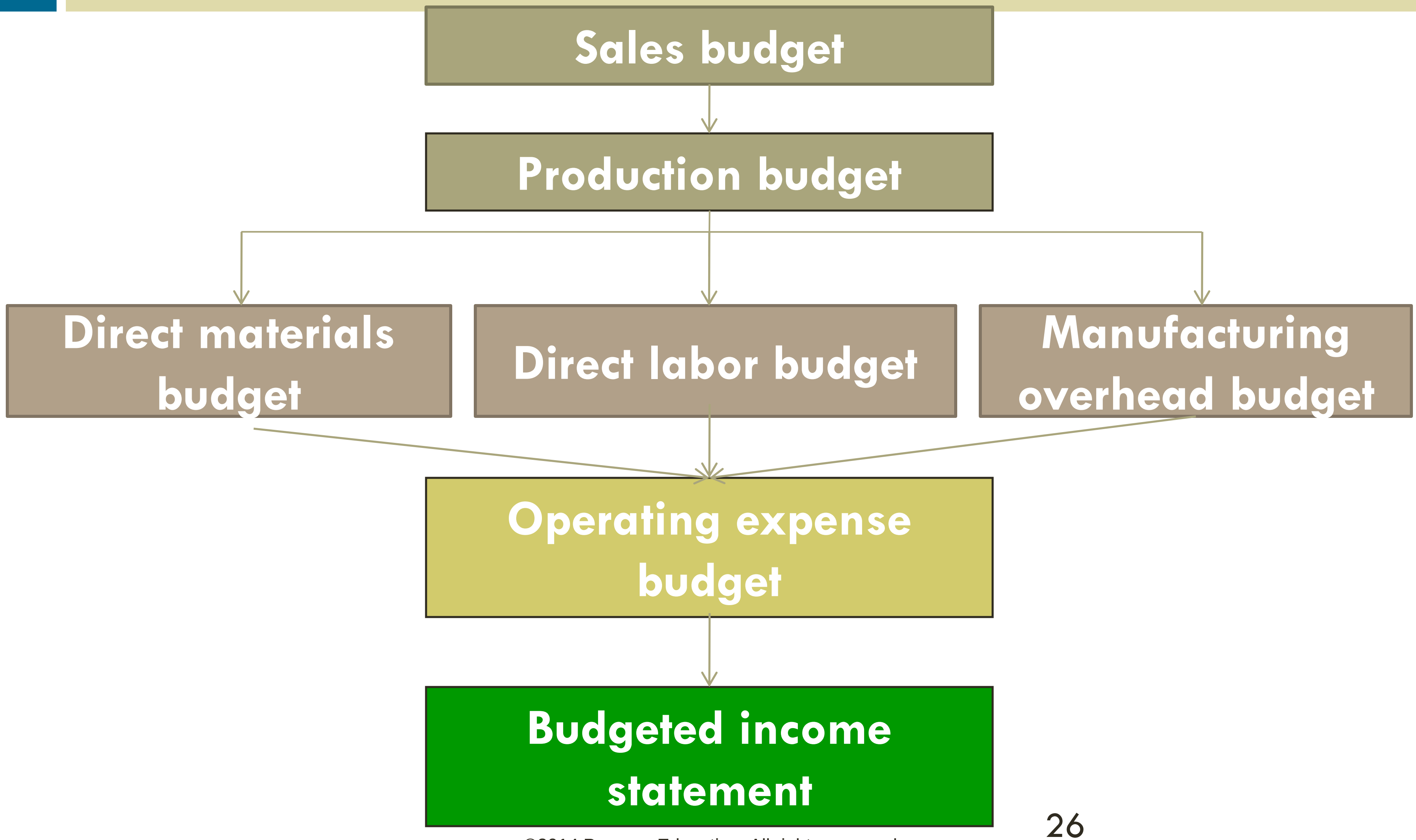
Basic Steps Common for Developing the Operating Budget

- Prepare the revenues budget
- Prepare the production budget
- Prepare the direct material usage budget and direct material purchases budget
- Prepare the direct manufacturing labor costs budget
- Prepare the manufacturing overhead costs budget

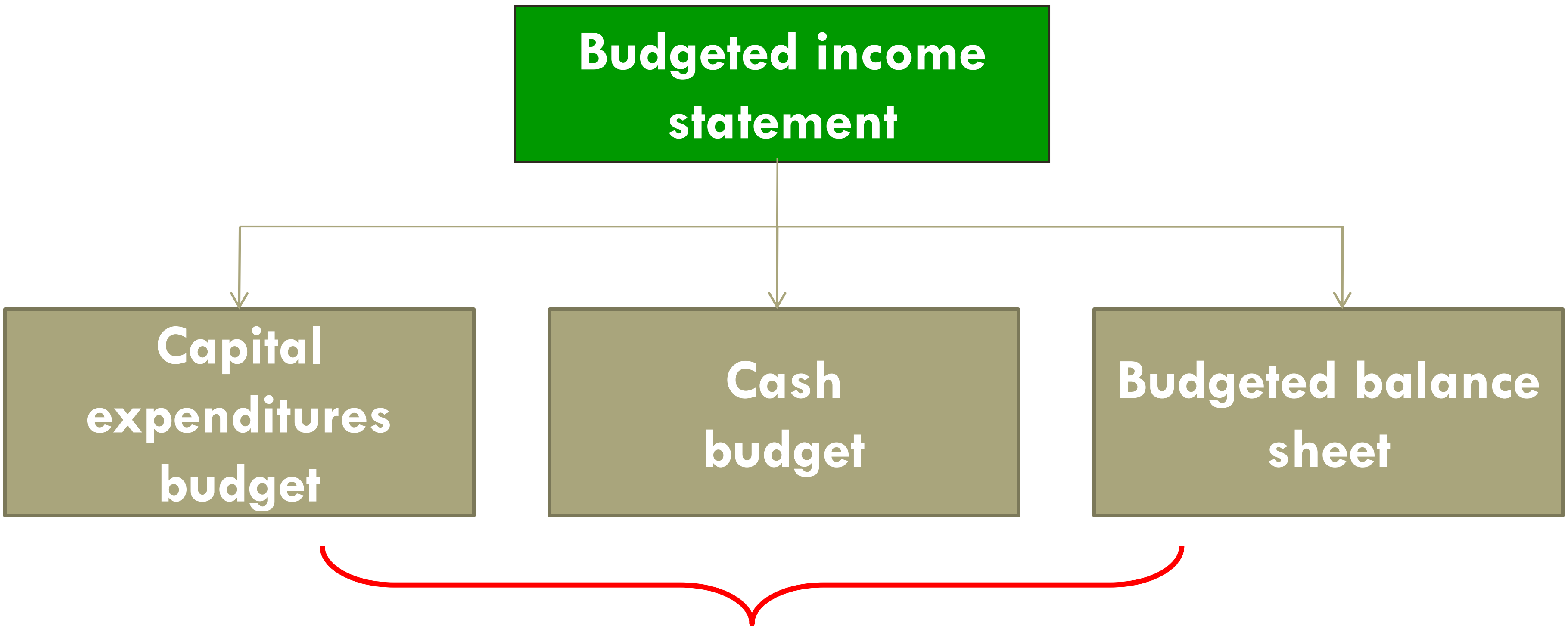
Basic Steps Common for Developing the Operating Budget

- Prepare the ending inventories budget
- Prepare the cost of goods sold budget
- Prepare the nonmanufacturing costs budget
- Prepare the budgeted income statement

Operating Budget



Financial Budgets



Financial budgets

Sales Budget

- Plan for sales revenues in future periods
- Number of units to be sold × Sales price per unit = Total sales revenue

Production Budget

+ Units needed for sales

+ Desired ending inventory

= Total units needed

- Units in beginning inventory

= Units to produce

Direct Materials Budget

\+ Quantity of DM needed for production

\+ Desired DM ending inventory

= Total quantity of DM needed

\- DM beginning inventory

= Quantity of DM to purchase

Direct Labor Budget

Units to be produced

× DLH per unit

= Total DLH needed

× Cost per DLH

= Total Direct Labor Cost

Use Computer-Based Financial Planning Models for Sensitivity Analysis

Learning Objective 5

Financial Planning Models

- They are mathematical representations of the relationships among operating activities, financing activities, and other factors that affect the master budget
- Managers can use computer-based systems, such as enterprise resource planning (ERP) systems, to perform calculations for these planning models

Sensitivity Analysis in Budgeting

- Sensitivity analysis is used to assist managers in planning and budgeting
- Sensitivity analysis is a “what if” technique that that examines how a result will change if an underlying assumption changes

Controllability

- It is the degree of influence that a specific manager has over costs, revenues, or related items for which he or she is responsible
- A controllable cost is any cost that is primarily subject to the influence of a given responsibility center manager for a given period

Recognize the Human Aspects of Budgeting

Learning Objective 6

Human Aspects of Budgeting

- Human factors are crucial in budgeting
- Budgeting is thought of as a mechanical tool
- However, the administration of budgeting requires education, persuasion, and intelligent interpretation

Budgetary Slack

- The practice of underestimating budgeted revenues, or overestimating budgeted expenses, in an effort to make the resulting budgeted goals (profits) more easily attainable

Avoiding Budgetary Slack

- Companies use budgets primarily for planning and not performance evaluation
- Obtain good benchmark data when setting the budget
- Practicing rolling budgets
- Managers involve themselves regularly in understanding what their subordinates are doing

Stretch Targets

- Challenging but achievable levels of expected performance
- Intended to create a little discomfort
- The more a company tries to push performance, the greater the emphasis it must place on following the ethics of the company

Kaizen Budgeting

- It explicitly incorporates continuous improvement anticipated during the budget period into the budget numbers

Exercise 7-2A *Preparing a sales budget*

Welch Company, which expects to start operations on January 1, 2011, will sell digital cameras in shopping malls. Welch has budgeted sales as indicated in the following table. The company expects a 10 percent increase in sales per month for February and March. The ratio of cash sales to sales on account will remain stable from January through March.

Sales	January	February	March
Cash sales	$ 40,000	?	?
Sales on account	100,000	?	?
Total budgeted sales	$140,000	?	?

Required

a. Complete the sales budget by filling in the missing amounts.

b. Determine the amount of sales revenue Welch will report on its first quarter pro forma income statement.

Exercise 7-3A *Preparing a schedule of cash receipts*

The budget director of Ginger's Florist has prepared the following sales budget. The company had $300,000 in accounts receivable on July 1. Ginger's Florist normally collects 100 percent of accounts receivable in the month following the month of sale.

	July	August	September
Sales Budget			
Cash sales	$ 70,000	$ 75,000	$ 80,000
Sales on account	90,000	108,000	129,600
Total budgeted sales	$160,000	$183,000	$209,600
Schedule of Cash Receipts			
Current cash sales	?	?	?
Plus: Collections from accounts receivable	?	?	?
Total budgeted collections	$370,000	$165,000	$188,000

Required

a. Complete the schedule of cash receipts by filling in the missing amounts.

b. Determine the amount of accounts receivable the company will report on its third quarter pro forma balance sheet.

Exercise 7-4A *Preparing sales budgets with different assumptions*

Applebaum Corporation, which has three divisions, is preparing its sales budget. Each division expects a different growth rate because economic conditions vary in different regions of the country. The growth expectations per quarter are 4 percent for East Division, 2 percent for West Division, and 6 percent for South Division.

Division	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
East Division	$100,000	?	?	?
West Division	300,000	?	?	?
South Division	200,000	?	?	?

Required

a. Complete the sales budget by filling in the missing amounts. (Round figures to the nearest dollar.)

b. Determine the amount of sales revenue that the company will report on its quarterly pro forma income statements.

Exercise 7-7A *Preparing an inventory purchases budget*

Naftel Company sells lamps and other lighting fixtures. The purchasing department manager prepared the following inventory purchases budget. Naftel's policy is to maintain an ending inventory balance equal to 10 percent of the following month's cost of goods sold. April's budgeted cost of goods sold is $75,000.

	January	February	March
Budgeted cost of goods sold	$50,000	$54,000	$60,000
Plus: Desired ending inventory	5,400	?	?
Inventory needed	55,400	?	?
Less: Beginning inventory	5,000	?	?
Required purchases (on account)	$50,400	?	?

Required

a. Complete the inventory purchases budget by filling in the missing amounts.

b. Determine the amount of cost of goods sold the company will report on its first quarter pro forma income statement.

c. Determine the amount of ending inventory the company will report on its pro forma balance sheet at the end of the first quarter.

Exercise 7-8A *Preparing a schedule of cash payments for inventory purchases*

Sciara Books buys books and magazines directly from publishers and distributes them to grocery stores. The wholesaler expects to purchase the following inventory.

	April	May	June
Required purchases (on account)	$100,000	$120,000	$132,000

Sciara Books' accountant prepared the following schedule of cash payments for inventory purchases. Sciara Books' suppliers require that 90 percent of purchases on account be paid in the month of purchase; the remaining 10 percent are paid in the month following the month of purchase.

Schedule of Cash Payments for Inventory Purchases

	April	May	June
Payment for current accounts payable	$90,000	?	?
Payment for previous accounts payable	8,000	?	?
Total budgeted payments for inventory	$98,000	?	?

Required

a. Complete the schedule of cash payments for inventory purchases by filling in the missing amounts.

b. Determine the amount of accounts payable the company will report on its pro forma balance sheet at the end of the second quarter.