The application of accounting to business planning

A budget is a **quantified plan of action** for a forthcoming accounting period.

The planning and control cycle

The planning and control cycle has seven steps.

Step 1. Identify **objectives**

Step 2. Identify potential **strategies**

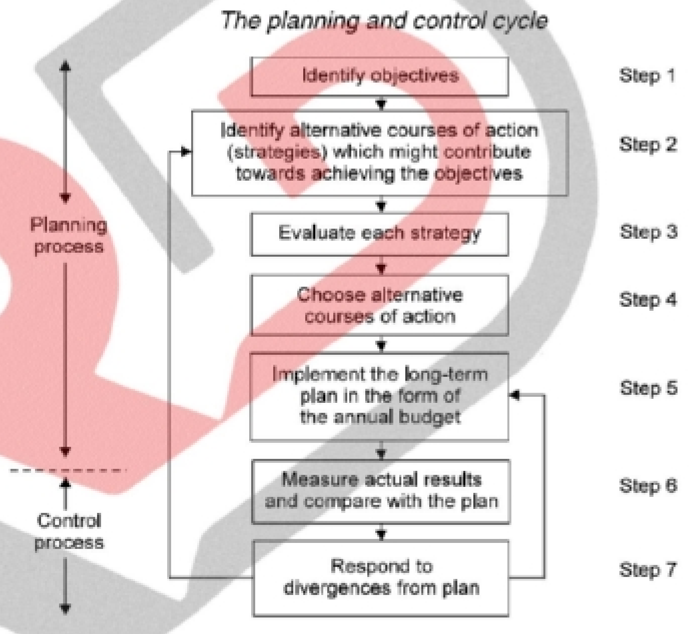
Step 3. Evaluate strategies

Step 4. Choose alternative courses of action

Step 5. Implement the long-term plan

Step 6. Measure actual results and compare with the plan

Step 7. Respond to divergences from the plan



Objectives of budgetary systems

- Ensure the achievement of the organisation's objectives
- Compel planning
- Communicate ideas and plans
- Coordinate activities
- Provide a framework for responsibility accounting
- Establish a system of control
- Motivate employees to improve their performance

Behavioural implications of budgeting

(a) The **managers who set the budget** or standards are **often not the managers** who are then made **responsible for achieving budget targets.**

(b) The **goals of the organisation as a whole**, as expressed in a budget, **may not coincide with the personal aspirations of individual managers**.

(c) **Control is applied at different stages by different people**. A supervisor might get weekly control reports, and act on them; his superior might get monthly control reports, and decide to take different control action. Different managers can get in each others' way, and resent the interference from others.

Criticisms of budgeting

(a) Budgets are time consuming and expensive.

(b) Budgets provide poor value to users.

(c) Budgets fail to focus on shareholder value.

(d) Budgets are too rigid and prevent fast response.

(e) Budgets protect rather than reduce costs.

(f) Budgets stifle product and strategy innovation.

(g) Budgets focus on sales targets rather than customer satisfaction.

(h) Budgets are divorced from strategy.

(i) Budgets reinforce a dependency culture.

(j) Budgets lead to unethical behavior.

Cost Classification

RAW MATERIAL	LABOUR	EXPENSES
Direct / Indirect	Direct / Indirect	Direct / Indirect

Prime cost= Direct Material + Direct Labor + Direct Expense

Overheads = Indirect Material + Indirect Labor + Indirect Expense

Overheads

• Production / Factory / Manufacturing Overheads

• Non Production / Non Factory / Non Manufacturing Overheads (E.g. Selling, Marketing, administration, Distribution, Office, Finance, R and D etc)

Building up of Costs

Direct Material	XX
Direct Labor	XX
Direct Expenses	XX
Prime Cost	XX
Add: Production Overheads	XX
Production Costs	XX
Add: Non Production Overheads	XX
Total Cost	XX

Direct costs
Direct cost are cost that can be traced / identified easily in the product or service being manufactured e.g. direct material, direct labor& direct expenses the sum of all the direct costs is known as the prime cost

Examples
• Cost of raw materials including carriage inwards on those raw materials.
• Labor directly involved in producing a unit or providing a service
• Hire of special machinery for a job or royalty expense

Indirect cost
indirect costs are costs that cannot be easily traced / identified in the product or service being manufactured or we treat them indirect because costs are negligible e.g. indirect material, indirect labor& indirect expenses the sum of all the indirect costs is known as the overheads

Examples

- wages of cleaners
- wages of crane drivers
- rent of a factory
- depreciation of plant and machinery
- costs of operating forklift trucks
- factory power
- factory lighting

Administration expenses

'Administration expenses' consist of such items as managers' salaries, legal and accountancy charges, the depreciation of accounting machinery and secretarial salaries.

Selling and distribution expenses

'Selling and distribution expenses' are items such as sales staff's salaries and commission, carriage outwards, depreciation of delivery vans, advertising and display expenses.

Financial charges

'financial charges' are expense items such as bank charges, discounts allowed and lease costs

<u>Classification by behavior</u>

Variable Costs: Variable costs arecosts that tend to vary with the level of Activity. More the activity more the costs and vice versa. Examples are material, wages etc

Fixed Costs: Fixed costs are costs that remains fixed for a particular range of activity. If the activity is within that range costs don't fluctuate. Examples are rent, depreciation, director's basic salary etc.

Semi-Variable Costs: Semi-variable or semi-fixed or mixed cost is a cost that includes elements of both variable and fixed costs. Examples includes utility bills, salesmen salary package etc

Stepped Fixed Costs: Stepped fixed costs are costs that remain fixed for a particular activity but as soon as the activity increases from that particular range costs increase in a stepped fashion and then again it becomes fixed for next activity range. Examples include supervisor salary, van costs, teacher cost etc

Total Costs is the total of variable and fixed costs

Sunk Costs: Sunk costs, historical costs are costs that incurred in the past and are no longer relevant for decision making.