Budgets Theory

Definition
A budget is a financial plan for a specific period of time in the future.

What is the purpose of Budgeting? Why is budgeting important?
- Compare actual figures with budgeted figures
- Variances can be identified
- Action can be taken if there is a variance

Outline The Advantages of Budgeting To A Business.
- Provide advance warning of potential difficulties.
- Provide a method of comparing budgeted with actual performance.
- Are helpful when trying to attract investment.
- Can be used as a decision-making resource.
- Are useful for providing direction and motivation to staff.

Explain the Term Budgetary Control.
This is the process of preparing a budget, observing whether the actual outcomes exceed or fall short of the budget, identifying the reasons for the observed differences, and then deciding what courses of action should be taken before preparing the next budget.

What Is An Adverse Variance and What Does It Show?
This is where the difference observed between an actual cost or revenue and the previously budgeted amount is worse (e.g. budgeted expenses turn out to be higher or budgeted income turns out to be lower).

Why Might An Adverse Variance Arise in Direct Materials?
If the purchase price increased.
If higher quantities were required.

Explain With Examples, ‘Controllable’ and ‘Uncontrollable’ Costs.
Controllable costs are costs over which the firm exercises power, such as wages, whereas an uncontrollable cost falls outside the direct power of the firm, such as price of raw materials.

What Factors Does The Firm Take Into Account When Calculating Their Budgeted Sales Figure For The Year?
- Last year’s sales.
- The state of the economy.
- Sales of competing firms.
- Results of market research.
- Trends in the market.

Explain ‘Principle Budget Factor.
This is the element that restricts the firm from expanding indefinitely. This might be the demand for the product or the production capacity of the factory or the availability of capital.

Explain What Is Meant By A Capital Budget.
A capital budget consists of the large-scale or long-term revenue and expenditure that a firm expects to incur. These items are normally once-off events such as the construction of a building or the receipt of a Government grant.

Define ‘Cash Budget’ and Describe Two of Its Advantages.
A cash budget is an estimate of the future income and expenditure of the firm.

Cash budgets enable the firm to identify periods of time in the future when difficulties may arise and also provide a method of comparing the firm’s actual performance with the previously budgeted figures.

What to do with a cash surplus?

- Invest the surplus to gain interest
- Use it to pay off loans
- Purchase fixed assets

What to do with a cash deficit?

- Arrange alternative finance (an overdraft from a bank)
- Request longer periods of finance (re-evaluate debentures and pay them back over a longer period of time)

Why Are Flexible Budgets Prepared and What Do They Show?

Flexible budgets are used to show how costs are likely to change at different levels of production. They show the different variable and mixed costs at different production outputs and also enable the firm to predict profit at these outputs. Actual costs can later be compared with these budgets to measure performance and plan for the future.

Explain How Budgeting Solves The Problem of Mixed Costs.

A mixed cost is one that is partly fixed and partly variable. The 'High- Low' method is used in budgeting to separate these two elements of the cost and to make it possible to make predictions about changes to the mixed cost as production levels vary. The 'High-Low' method finds the difference between the costs and units and then divides one into the other to give us the variable portion of the cost. This then makes it possible to identify the fixed portion.