



BUDGETING PRINCIPLES AND APPROACHES



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Executive Summary

The purpose of this report is to analyse the importance of budgeting techniques within the business Environment. Budgets are used for making forecasts of expenditures and revenues incurred in order to judge the future risk. Here, different problems reflected by the budgeting process and procedure to solve the problems are provided for rubber soul.

Besides this, the situation required to launch the budgeting is also provided to make it successful. Budgeting strategy also changes with the change in business environment and behavior of peoples within the management. Human behavior is so dynamic and cannot be ascertained easily.

In order to make budgeting techniques successful, steps need to be taken are also considered below. Including this, the traditional budgeting techniques in modern world and in context to competitive environment needs is also evaluated. Inherent flaws under the same are also included as a part of it.

This report will provide a detailed understanding in context with importance of budgeting, budgeting methods, budgetary control, average inventory, inventory turnover, traditional budgeting approach, pros and cons of traditional budgeting, cost accounting, accounting for decision making etc.

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Introduction

The term budgeting provides for such plans made by the individuals or an entity in relation to the allocation of its expenditures. It is a guideline for future action plans, expressed in financial terms over a specified period of time. According to CIMA Official Terminology, (2005) - 'A budget is a quantitative expression of a plan for a defined period of time. It may include planned sales volumes and revenues, resource quantities, costs and expenses, assets, liabilities and cash flows.'

The most common budgeting methods include incremental budgeting, activity-based budgeting, value proposition budgeting and zero-based budgeting. Each of these methods has its advantages and disadvantages. For example, incremental budgeting is effective in situations where both income and expenditure increase by a predictable amount each year. On the other hand, zero-based budgeting can be useful for cost reduction because this budgeting method requires justification of each line item expense.

According to Murphy, (2020) - Budgeting helps the planner to get an estimate about his future spends and other balances in advance way; If the person is getting surplus at the end, it would be known as surplus budgeting; If the revenues become equal to the total allocation, then it would be called as balanced budgeting. But if the cash balances are forecasted to be in deficit then it would be stated as deficit budgeting. In the following report, analysis for the given data Rubber Soul is provided for next six months i.e. from July to November end. Problems regarding the same and their solution are addressed within the context provided below. In another part some of the condition are also discussed which are required as existing in order to execute a successful budgeting process. Behavior and changes are considered by management for introducing the system is cost to be introduced. In the last section of subheading to be included, traditional methods and their utilities in relation to dynamic environment is also discussed. This report has been prepared with the help of various sources and own research. Books, academic journals, websites and class lectures are among those sources.

Main Findings

a) Stock budget, Cash budget and Profit & loss

According to Walsh, (2008) - Key management ratios are a financial tool that is an active component in analyzing the financial position of an organization. The stock budget helps to determine the expected cost of the stock and the minimum stock level of the company. The cash budget helps on the expected cash inflows and outflows and borrowing financial issues. The budgeted profit and loss account helps to determine the expected gross profit, operating cost and operating profit for time.

In below, a comprehensive analysis of Rubber Soul Company's projected financial position by reviewing its six-month stock budget, cash budget, and profit and loss account.

The stock budget for the six months to 30 November is:

i)	June	July	Aug	Sept	Oct	Nov
	£000	£000	£000	£000	£000	£000
Opening balance	105	124	130	158	190	176
Stock purchased	<u>180</u>	<u>160</u>	<u>203</u>	<u>200</u>	<u>140</u>	<u>195</u>
	285	284	333	358	330	371
Cost of Stock sold						
(70% of sales)	<u>(161)</u>	<u>(154)</u>	<u>(175)</u>	<u>(168)</u>	<u>(154)</u>	<u>(147)</u>
Therefore Closing stock	<u>124</u>	<u>130</u>	<u>158</u>	<u>190</u>	<u>176</u>	<u>224</u>

The cash budget for the period to 30 November is:

	June	July	Aug	Sept	Oct	Nov
	£000	£000	£000	£000	£000	£000
Cash receipts						
Sales net of 0.3 X 3% (Note 4)	228	218	248	238	218	208
Cash payments						
Administration (Note 5)	(19)	(18)	(16)	(17)	(17)	(15)
Stock purchased (Note 2)	(205)	(180)	(160)	(203)	(200)	(140)
Repayments of loan (Note 4)	(5)	(5)	(5)	(5)	(5)	(5)
Selling expenses (Note 6)	(6)	(8)	(7)	(6)	(8)	(9)
Taxation paid	-	-	(20)	-	-	-
Interest payments	(1)	(1)	(1)	(1)	(1)	(1)
Shop refurbishment	<u>(11)</u>	<u>(10)</u>	<u>(12)</u>	<u>-</u>	<u>-</u>	<u>-</u>
Cash surplus (deficit)	(19)	(4)	27	6	(13)	38
Opening balance	<u>22</u>	<u>3</u>	<u>(1)</u>	<u>26</u>	<u>32</u>	<u>19</u>
Closing balance	3	(1)	26	32	19	57

- ii) The (*accruals-based*) budgeted Profit & Loss Account for the six months ending 30 November is:

	£000	Calculation
Sales	1370	230+220+250+240+220+210
Cost of goods sold	<u>(959)</u>	therefore 1370 X 70%
Gross profit	411	40% X 1370 (Note 3)
Selling expenses	(44)	8+7+6+8+9+6
Admin Expenses	(144)	26+25+23+24+24+22
Credit card charges	<u>(12)</u>	1370 X 30% X 3% (Note 4)
Operating profit	211	
Interest payable	<u>(6)</u>	6 months X 5,000 X 20% (Note 4)
Profit for the period	<u>205</u>	

b) Evaluation of Problems using cash budget information for Rubber soul

Problem 1:

High level of cost of sales: Rubber soul is bearing high level of cost of sales. Due to these high purchase and direct costs, the profit level is decreasing. The current level of Gross profit ratio for the six-month period lies at 30%. For a company like rubber soul, the desired level for GP lie between 50%-70%. Above levels are showing that company is bearing high cost of manufacture directly related to the product. Total costs of goods sold is equal to 70% of total costs (Marr, 2012).

Problem 2:

Decrease in total cash sales: Company cash sales is decreasing over the time period which shows that company selling efficiency is decreasing. It was £228000 in June which decreased to £208000 in end of November. This may be due to increase in company expenses and decrease in efficiency level. This may impact its long term profitability.

Problem 3:

Increase in closing stock: The stock levels with the company are increasing month by month. This may increase maintenance expenses for the company. According to Lu, and et.al., (2022) - Increase in such expenses would decrease the profitability levels for the company.

Problem 4:

Credit card charges: Company is currently bearing 3% of credit card charges of total cash sales receipts from online mode. Increase in total sales from online mode may also lead to increase in total charges. According to Yalico, and et.al., (2020) - This may impact company current profitability due to increase in expenses incurred by the company.

Problem 5:

Increase in company selling expenses: From Note 4, it can be analyzed that the company net selling expenditure is decreasing (Chan, and Adabre, 2019). While sale figure in cash are

showing downward trends for the company. From this it can be analyzed that the company is failing to derive more sales by increased expenditure. The sales were £ 228000 when the selling expenses were about £ 6000 for the company during month of June. At the end of November, the total expenditure on selling and promotion activities was 9000 while the company sales decreased to £ 208000. This indicates that company is using wrong methods which are not supporting their sales figures.

Problem 6:

Cash deficits: From the given cash budget for the rubber soul it is concluded that company faced cash deficit in month of June, July and October (Isensee and et.al., 2020). This also provides that company is not able to generate the required cash revenues to meet its operating cash requirement.

Problem 7:

Inventory turnover ratio: According to Zhang, (2019) - Inventory turnover ratio of accounting indicates the company efficiency to convert the existing stock with the company into sales. This provides some quantitative analysis and facts for the given data provided. According to the above case the inventory turnover ratio for the company is as follows:

Given under stock budget:

	June	July	Aug	Sept	Oct	Nov
	£000	£000	£000	£000	£000	£000
Opening balance	105	124	130	158	190	176
Stock purchased	<u>180</u>	<u>160</u>	<u>203</u>	<u>200</u>	<u>140</u>	<u>195</u>
	285	284	333	358	330	371
Cost of Stock sold						
(70% of sales)	<u>(161)</u>	<u>(154)</u>	<u>(175)</u>	<u>(168)</u>	<u>(154)</u>	<u>(147)</u>
Therefore Closing stock	<u>124</u>	<u>130</u>	<u>158</u>	<u>190</u>	<u>176</u>	<u>224</u>

Formula: Cost of goods sold / Average inventory

Average inventory: (Opening Inventory + closing inventory) / 2

	June	July	Aug	Sept	Oct	Nov
	£000	£000	£000	£000	£000	£000
Opening balance	105	124	130	158	190	176
Therefore Closing stock	124	130	158	190	176	224
Cost of Stock sold	161	154	175	168	154	147
Average inventory	167	189	209	253	278	288
Inventory Turnover ratio	0.96407	0.81481	0.83732	0.66403	0.55396	0.51042

From the given analysis it can be concluded that the company turnover ratio in terms of inventory is decreasing time to time. It was about 0.96 during the month of June which decreased to 0.51 in November which shows inability of concern to convert their existing stock into sales. It may be due to use of wrong sales and promotion strategy. The selling expenses are increasing while its sales are decreasing. This may be great risk for the company in upcoming future. It may lead to increase in other related expenses like warehouses costs and misc. cost etc.

Management actions to address these problems:

Solution for the given problems is as follows:

Solution 1:

In order to decrease cost of sales for the company, it is recommended that company must purchase their raw material in bulk for receiving more discount on per unit cost prices. Better relation with the suppliers and leverage policy may also provide additional benefits to the company in terms of cost. Better use of technology and manpower efficiency may be an add-on to this.

Solution 2:

Company cash sales is decreasing on an alarming rate. Company management may increase the sales by innovating their product design, changing sales price according to the substitutes price levels in market, and using advanced marketing tools and techniques for better promotion. Consumer is considered to be a central element to management. Company must prepare their product and price strategies with keeping their potential consumers requirement in mind.

Solution 3:

Company closing stock levels are increasing. This may lead to increase in requirement of maintenance and relate expenses for the company. Company may heal this situation by employing advanced tools for increasing sales figures for the company.

Solution 4:

In order to get rid of credit card charges, the company must try to derive its sales through direct contact with consumer. It can be done through creating personal company website and making it open for sale and purchasing matters. Company may promote its product through advertising and redirecting its purchaser to their main website.

Solution 5:

Company selling expenses are increasing but sales are decreasing. This can be healed through using the innovative sales techniques, social media marketing and cost effective techniques for promotion of products. Internet and social media is basically used to increase the area of coverage and consumer base. This could be an effective measure to solve such problem.

Solution 6:

Company is facing some cash deficit issues. This may make company unable to meet its current obligations. Company may heal this by eliminating non-required expenses in order to decrease the level of deficit. Increase in cash sales may solve this difficulty and increase opening cash for the next period for company usage.

Solution 7:

The turnover ratio for inventory is decreasing. Increasing ratio provides that company is converting its goods into sales with better efficiency. It is completely based on sales of company. Increase in sales would help company management to increase their inventory turnover ratio.

c) Condition required for making budgeting successful

An organisation is a group of many individuals organised in chain of authority and work together in order to achieve the main aim. Such aim is setup by business management and owners to reach within prescribed period. According to Drury, (2013) - An organisation make different types of plans within the life cycle of business. Planning is a process of thinking in advance and ascertaining the future condition in order to diminish uncertainties. Financial planning is a part of same where the officials like finance personnel and company accountant make budgets for company expected revenues and its allocations for the provided period. During this, they also ensure some essential condition and elements which need to be exist for successful execution. Major elements are as follows:

1. Well defined structure: According to Mitreḡa, (2020) - Organisation hold mainly three types of resources i.e. physical, financial and human resources. All of them are needed to be organised in a well manner in order to get a perfect execution of plans. Better organisation setup and well defined authority and responsibility help in easy identification of units for sound budgeting process.
2. Clear targets: Well defined objectives and targets help in easy identification of action, which are needed to be taken for achieving the target in specified manner. Business also make some supporting plans in line with the long term plan for assigning reasonable cost to every task of the plan execution. This is only possible in case of clear tasks (Kober, and Thambar, 2022).
3. Clear responsibility: Budgeting process could be operated in a smooth manner in case when there is clearly defined authority and responsibility in an organisation. It would be easy to locate person held accountable for given task. It would also help in easy communication (Demartini, and Otley, 2020).
4. Flexibility: Budgets prepared by the organisation must be prepared in such way so that they could be altered in accordance to dynamic business environment situation. They must be created on some basis for future period of time.
5. Committed to budget: Each and every person must adopt and follow the condition mentioned in future budget made by the management officials.

6. Controlling: According to Kaufman, and Covaleski, (2019) - The standard budgets must be considered during the actual performance within the organisation.
7. The standards act as a targets needed to be attained in reality. According to Torfing, and et.al., (2020) - If any variances are found during the verifying process, such deviation must be resolved on priority basis in order to achieve best efficiency and effectiveness.

Behaviour of People to be considered during introduction of Budgeting:

According to Bhimani, (2006) - Management is a full-fledged process of planning future actions, organising business resources, employing the workers, directing the employees and controlling the functions at end in order to achieve the main aim effectively and efficiently. During the process of budgeting it is very essential to consider each and every functions and action to performed during the business process. It may impact budgeting process for the concern. Some of the points related to people behaviour to be taken into consideration are as follows:

1. **Interdepartmental clashes**: The process of budgeting the action plans are a formal and very tricky process. It requires best track to business needs and clear coordination between different department and individuals working under it. Personal clashes and conflict may lead to failure of budgeting process which is not good for business stability (Cohen and et. al., 2019). In order to solve the issues, distrust and bitterness is needed to be reduced. This would improve their participation and level of dedication to employees.
2. **Concept of communication and relationship**: According to Giles, and et.al., (2021) - Subordinates are accountable to their concerned superiors for the task provided to them. It is called formal relation. Communication helps them to transfer their views from one person to another. This facilitates better effectiveness at work and trust upon their superiors. Increase in faith and understanding between both helps to conduct easy and fair budgeting process.
3. **System of appraisal and motivation**: Every person in an organisation requires to fulfil their needs according to the provided hierarchy. Motivation and self-esteem refers to the fourth level of need where the person likes to get appraised for their

work. Through this it can be motivated for better performance. According to Stentoft and et. al., (2021) - During budgeting process, management must consider all needs related to costs of training and motivation for achieving better dedication level of employees in budgeting process.

4. **Willingness to accept budgets:** According to Kasilingam, (2020) - Budgeting helps in creating balance and better coordination between existing plans and activities within the organisation. Goals and standard to be achieved must be tightened up to some extent. They must encourage participative approach, and motivate the organisational personnels. Budgeting could become successful only if people are ready to accept it. Willingness of each and every person helps in achieving better efficiency throughout the run (Portos, 2021).

d) Traditional approach to budgeting and changes in relation to dynamic business Environment

According to Atrill and McLaney, (2009) - Traditional budgeting refers to such techniques and methodologies which considers last year figures as base for make future forecasts. It uses the last expenditure levels and needs of changing business environment for more add-ons in last year figures. Changes made to last year budgets are done by considering the changes in external and internal business environment. It also studies the financial and non-financial factors impact for optimum budgeting process.

Traditional budgeting involves very common and simple steps to carry out the budget forecasts. It not only discovers future earning and losses but also ascertain the level of profits expected by business. This helps in exercising better control over business allocation and spends which leads to better profits in future. It is not accurate to fuller extent but it helps to provide a basic idea related to future trends and requirement. But it had also become a subject of controversies as its non-followers think that it must be replaced by beyond budgeting and other modern techniques to meet the changing environment requirements (Bressan, and et.al., 2021). Many alternative approaches are also introduced but still, it is considered as a very useful element in modern times because of the following advantages provided below:

- Incremental methodology: Traditional budgeting uses an incremental approach by considering the impact of inflation on sales and total costs, on annual budgets etc. It includes quantitative aspect in order to assess the action plan for the given task.
- Defined approach: According to Stoyanova-Bozhkova, (2022) - Defined approach uses cash flow analysis, expenditure made by concern, revenues earned and liabilities incurred for a fixed time period. It uses top to down hierarchical approach for making budgeted analysis.
- Better flexibility: The central budgets are prepared according to the needs of the sub-departments and then sub departments review the main budgets and alter them according to them. It provides better flexibility to their users.
- Helps in value creation: According to Mohammed, (2021) - Value creation increases sustainability of companies by increasing the coordination between department and

individuals, facilitates communication, and provide better review for optimum pricing decision.

Usefulness of traditional budgeting in relation to today business requirements:

It emerged as a best tool for planning, management and business assessment for better controlling purposes. It is believed as a best tool for evaluation by management officials and business directors. They think that business can be easily managed through traditional budgeting, without delegating any authority and power with subordinates of the company (Midgle and et. al., 2019). Traditional budgeting usually suits every business environment as it is very easy to adopt and execute to meet daily expectation of general businesses.

Business environment is considered as very dynamic. Hence it is understandable that the use of single method or technique cannot meet the dynamic requirements. Hence mix of all the budgeting techniques in a relevant manner can help out business to cope up with the changing needs of environment. Business must change according to the changing requirements in order to increase its competitiveness in dynamic business surroundings. Traditional techniques enable its users to achieve this. According to Kwandayi, (2021) - Better understanding of business environment and own business cultures helps in combining budgeting approach to business in a better way.

Inherent flaws in traditional budgeting methods: Besides advantages and benefits, traditional budgeting methods also contain some inborn limitations and problems which are provided below:

- **Non economical on cost basis:** According to Withers and Zoltani, (2020) - The traditional costing techniques involves high level costs and uses high level of business resources . This may restrict company to achieve rational management during the business management. In addition to this, it is prepared by humans, so it may also contain human errors. It may not be accurate every time in changing business environment.
- **Less flexibility:** Business environment is considered to be very dynamic. According to Siddiquee and et. al., (2019) - Business make changes to their organisational policies, and structures in order to meet the environmental needs. They do so in order to increase their profitability and competitive stability in long run. Traditional techniques and tools are static in nature and they could not be changed according the

needs and demand of the times. They also not help business to derive full description and snapshot for optimum budgeting analysis in future. It cannot meet the need for the times hence it is not preferred by new entrepreneurs and managers.

- **Centralization of authority:** In today's era, usually most of business use participative style of management. It is used to promote better communication, recognition & to increase level of motivation within the workers. Traditional mode of forecasting involves a centralization of whole budgeting process in individual or few hands. This decreases accuracy and balances of budgeting process. According to Hiromoto, (2019) - Nowadays, businesses use collaborative approach today for better environmental analysis and decision making. But traditional budgeting does not adopt this.
- **Lack of value creation:** Traditional processes generally use and prefer cost reduction methods rather generation of new valuable prospects for business firm. Business strategy cannot be linked with plans created through traditional mode of forecasting.
- **Time taking process:** It is a very time consuming process in every concern uses it. According to Ahn and et. al., (2021) -Traditional budgeting method uses past trends and forecasts for future basis. It mainly focuses on decrease business costs. It does not encourage business to take risk as uses risk resistive approach.

Limitation in modern context:

Business employ more and more cost effective and efficient tools in order to achieve great efficiency. According to Strikwerda, (2023) - The traditional cost techniques are not supported by most of the business managers; because it may be due to the limitations like high time consumption, low level of flexibility, lack of response to the change in environmental factors etc. In response to this they usually prefer to use a combination of traditional techniques with modern ones in order to achieve best results in long business run.

Conclusion

From the above analysis, it can be concluded that cash budgets for rubber soul are showing poor condition and lack of liquidity in company. The efficiency of rubber soul is decreasing and there also existing some problems which needed to be addressed on priority basis. This may help company to get rid of existing glitches in future period.

Besides this, some points regarding traditional budgeting techniques are also discussed. Behavioral requirements to budgeting and changes needed to be made in it are also discussed in relation to changing modern business environment demands. Along with this some usefulness and inherent flaws are also determined. Every business management use different approach to budgeting techniques. Some rely on single methods while some of them use mix of a combination for achievement of better efficiency. Change in business dynamic environment also impact such organizational decision making.

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Appendix

Calculations:

STOCK BUDGET

Cash of good sold (70% of sales) :

(Sales income X Gross profit margin)

June	: 230,000 X 70% = 161,000
July	: 220,000 X 70% = 154,000
August	: 250,000 X 70% = 175,000
September	: 240,000 X 70% = 168,000
October	: 220,000 X 70% = 154,000
November	: 210,000 X 70% = 147,000

CASH BUDGET

Cash Receipts :

(Net Sales X Credit card sales X Credit card charge)

Sales net of 0.3 X 3%

June	: 230,000 X 0.3 X 3% = 2070	
	So, (230000 - 2070) = 227,930 OR. 228,000	
July	: 220,000 X 0.3 X 3% = 1980	
	So, (220,000 - 1980) = 218,020 OR. 218,000	
August	: 250,000 X 0.3 X 3% = 2250	
	So, (250,000 - 2250) = 247,750 OR. 248,000	
September	: 240,000 X 0.3 X 3% = 2160	
	So, (240,000 - 2160) = 237,840 OR. 238,000	
October	: 220,000 X 0.3 X 3% = 1980	
	So, (220,000 - 1980) = 218,020 OR. 218,000	
November	: 210,000 X 0.3 X 3% = 1890	
	So, (210,000 - 1890) = 208,110 OR. 208,000	

Aministration expenses :

June : $26,000 - 7,000 = 19,000$

July : $25,000 - 7,000 = 18,000$

August : $23,000 - 7,000 = 16,000$

September : $24,000 - 7,000 = 17,000$

October : $24,000 - 7,000 = 17,000$

November : $22,000 - 7,000 = 15,000$