

**Module Name/Code: Principles and Concepts of
Finance/BMBM5017**

Title: Budgeting Principles and Approaches

Host Organisation: Neural LTD

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Executive Summary

The principle of budgeting systems is an essential component in any business in its survival and sustainability. The managing of control systems is essential as it facilitates the system of planning, control and coordination for management to run operations smoothly. There are many approaches to utilising budgeting to suit company requirements and in understanding the fundamental principles on how to maximise the criteria then can organisations begin to adapt, implement and practice the systems to benefit for the future environment.

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1.0 Introduction

On the 9th of January 2023 the author of this report has been requested by Neural LTD to publish its findings on the principles of financial management while addressing concepts of financial management in business situations in relation to costs and revenues. The author will also publish findings on different budgeting methods while critically discussing the benefits and drawbacks of such budgeting approaches. The author who completed this report is Masuk Ali. The report is to be submitted by the 31st of March 2023. The author will compile the report by undertaking information from books, websites and articles to underpin arguments.

2.0 Findings

2.1 Stock Budget (See appendix 1)

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

	June	July	Aug	Sept	Oct	Nov
	£000	£000	£000	£000	£000	£000
Opening balance	105	147	175	228	284	292
Stock purchased	<u>180</u> <u>285</u>	<u>160</u> <u>307</u>	<u>203</u> <u>378</u>	<u>200</u> <u>428</u>	<u>140</u> <u>424</u>	<u>195</u> <u>487</u>
Cost of Stock sold (60% of sales)	<u>(138)</u>	<u>(132)</u>	<u>(150)</u>	<u>(144)</u>	<u>(132)</u>	<u>(126)</u>
Therefore, Closing stock	<u>147</u>	<u>175</u>	<u>228</u>	<u>284</u>	<u>292</u>	<u>361</u>

2. The cash budget for the period to 30 November is:

	June	July	Aug	Sept	Oct	Nov
	£000	£000	£000	£000	£000	£000
Cash receipts		218	248	238	218	208
Sales net of 0.3 x 3%	228					
Cash payments						
Administration	(19)	(18)	(16)	(17)	(17)	(15)
Stock purchased	(205)	(180)	(160)	(203)	(200)	(140)
Repayments of loan	(5)	(5)	(5)	(5)	(5)	(5)
Selling expenses	(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>(41)</u>	<u>(45)</u>	<u>(18)</u>	<u>(12)</u>	<u>(25)</u>
Closing balance	(41)	(45)	(18)	(12)	(25)	13

3. 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>(822)</u>	therefore 1370x60%
Gross profit	411	30%x1370
Selling expenses	(44)	8+7+6+8+9+6
Admin Expenses	(144)	26+25+23+24+24+22
Credit card charges	<u>(12)</u>	1370x30%x3%
Operating profit	211	411-44-144-12=
Interest payable	<u>(12)</u>	6 months x 1000x20% (note 5)
Profit for the period	<u>199</u>	211-12 =

2.2 Identification of Problems at Neural LTD

Overdraft from the Bank

Neural LTD trading as Rubber Soul have been requested by the bank to make a repayment of £22,000 by the end of November. The directors have recently reviewed plans for the next six months. A bank overdraft enables companies to maintain a negative balance on its bank account. A benefit of an overdraft is that interest rates are competitive, and the overdraft is inexpensive to arrange. The drawback however of this form of finance is that it is to be repayable on demand. This can pose issues for companies who are illiquid. However, the vast majority of businesses operate for several years using an overdraft because banks maintain confidence in the company to repay and arrangements suit the business. So, in theory though overdrafts are regarded as a short-term solution can in practice suit as a long-term source of finance

(Atrill, 2014). According to Marr (2012) debt-to-equity (D/E) is how businesses can finance their operations via shareholder equity or by taking on debt. Understanding the amount to be financed by debt as opposed to shareholder investment (D/E) ratio is a key indicator of the financial position of a business. If the business has more debts than equity often referred to as gearing can mean that the business has been aggressive in financing its growth on debt though debt is not regarded as a negative as borrowing can finance growth. The drawback however, overusing such a leverage can strangle a company and leave earnings subject to interest expenses. Taking on the right level of debt can differentiate between a business that responds to the ever-changing economic conditions and one that is struggling to survive.

The author has identified in order to make this payment is to firstly try and talk with the bank on the amount of interest rate paid which is currently at £1000 and reduce this amount which can be manageable. Citizens Advice (2023) state that to fulfil this debt, Neural LTD needs to deal with the most important debts (priority debts) first that include, credit card charges, repayment of the loan, stock purchases and selling expenses. Neural LTD need to make a budget to see if the overdraft is affordable and be accurate in the figures. Only after essential bills are paid and there is money left over in the bank can then investigate paying off the overdraft. One option is to switch the bank account with an interest free overdraft as this will allow Neural LTD to pay off the overdraft without accumulating interest. Negotiations with the bank if Neural LTD run into difficulties might allow a temporary pause on the interest on the debt. Explaining the situation and the struggles to the bank might allow them to offer a repayment plan solution such as reducing the interest. If the bank declines any negotiations, then the budget that was set aside for the shop refurbishment will need to be subsidised to pay the overdraft. Renovations can be deemed a gamble with valuable income being reinvested. Renovation involves numerous essential work that need to be carried out for the shop to operate and there are often jobs that will occur which have not been accounted for proving costly. Another factor to take into consideration is the loss of trade while work is carried out which can affect trade with tight margins. The author suggests that the £31,000 budget put aside for the refurb can be utilised to pay the overdraft (Collard, 2022).

Administration costs

Currently Neural LTD administration costs vary monthly from £22,000-£26,000. The author believes that this can be reduced significantly by adopting cost effective strategies. Harvard Business Review (2010) state that relying on one single radical idea to change the structure of the department will be too risky and should rather plan towards a goal with 10 or more action combinations. It is ideal to implement incremental ideas with minimal impact on other departments which can allow up to 10% trim of costs. Dyson (2010) states that avoidable costs may be saved by not taking a particular decision and non-avoidable costs will still be incurred if the decision is taken. Though both costs are similar to relevant and non-relevant costs and are frequently used synonymously.

Here are a few cost saving activities:

- Combine activities such as training days into single events
- Instead of leaving vacant positions unfilled, restructure jobs of any less than fully busy staff and address underperformers
- Reduce miscellaneous spending such as office supplies like stationary by seeking approval from seniors can allow for 15%-20% savings
- Hold down pay increase. Check with HR to see employees are paid in standard to the marketplace and as long as the pay is not below market then consider holding average pay increase to 1%-2% less than last year's business average
- Closing facilities, downsizing to a smaller office and even moving to a cheaper area or building
- Reduce outside services such as advertising and contractors
- Implementing new technology such as a new piece of technology can replace a number of staff cutting labour costs.

(Business Harvard Review, 2010 and Kenton, 2021).

However, Kenton (2021) does state that while embarking on cost cutting it is vital to implement a strategy before arbitrarily cutting costs as some costs are necessary so there should be a classification of good, bad and best costs. According to Atrill (2014) managing finances effectively is useful for companies in preparation for projected cash flow statement. This is an important tool in planning and control purposes as projected cash flow statement allows managers to view how planned events are expected to affect the cash balance.

Costs that are easily identifiable are known as direct costs but there will be some identifiable costs classed as indirect costs where it can become difficult to relate them to units of production. Whether classed as direct or indirect costs the nature needs to be broken down into their elements (Dyson, 2010).

2.3 Successful Budgetary Systems

According to Drury (2021), budgeting relates to the implementation of a long-term plan for the year ahead and detailed budget management is a clear indicator of what is to be achieved during the budget period. Atrill and McLaney (2018) state that one reason things may not go according to plan is that budget targets may be unachievable, and it may be necessary to revise the budget for future periods and this point implies that budgets should be adaptable. To exercise control on budgeting is by:

- Preparation of budgets
- Performing and collecting information on performance
- Identifying variances between planned budget and actual performance
- Responding to variances between planned and actual performance and exercise control.

The directors need to set goals and objectives which serve as benchmarks to control and evaluate the situation. There are many budgeting systems that can be adopted to ensure business success.

2.3.1 Flexible Budget

According to Seal et al. (2012) using the flexible budget approach is a much better way of assessing whether overhead costs are under control. However, for organisations who offer a variety of products and services, this analysis will not provide simple as the number of units produced or customers served might not be an adequate measure of overall activity. Drury (2021) states that flexible performance standards are applied when targets are adjusted to reflect variations in uncontrollable factors arise from situations that were not part of the initial targets that were set. Here, flexible budgets can be used as some costs vary with changes in the level of activity. It is vital when applying the controllability principle to take into consideration the variability of costs such as if the activity level is greater than the budget level of activity then the variable costs associated with the activity will be greater than budgeted costs

due to the changes in activity. Benefits of adopting a flexible budget system are:

- **Taking advantage of opportunities** – if sales were to increase quickly, flexible budgets would be adjusted to increase spending on other avenues as variable expenses in flexible budgets are reflected as percentage of sales
- **Adjust for profit margins and changing costs** – unlike static budgets whereby costs of operation and profit margins are set at the start of the year based on previous data which does not stay the same in real life, flexible budgets can handle any changes as it would spot variances which will allow management to take corrective actions. It can however mean increase in price and effort to search for cost saving expenses
- **Better cost controls** – Flexible budgets react more effectively and quickly to adverse conditions for example if a budget was set up with an expectation of sales of \$200,000 a month and labour expense was budgeted at \$50,000 a month, if sales decline to \$150,000 a month (25% of sales), then labour cost should be reduced to \$37,000 (25% of \$150,000). Static budget would not adjust to the decrease in revenues and labour costs would stay the same.

(Woodruff, 2019).

2.3.2 Master Budget

According to Zoho Books (2021) a master budget is a cluster of low-level budgets that are created by different areas within a business. The system utilises input from the cast forecast, the financial plan and financial statements. Organisations use master budgets to plan activities that are needed to achieve business goals. Senior management within larger organisations are responsible for creating many variations of the master budget before one is to be finalised. Once reviewed for the final time. Monies can be allocated for the specific company activities. Smaller companies often use spreadsheets to create their master budget but by replacing this method with an efficient budgeting software will minimise errors. Indeed (2023) state that preparation of a master budget happens later in the planning process when the business has agreed on goals. After the initial data acquisition, a business creates a master budget with the following:

- **Create individual budgets** – department heads work to create all the individual budgets that are relevant to the business's sections and company assets. This budget will include all the department's income including fixed, variable and net profit/losses. The sales budget is the most significant factor in a master budget
- **Compile individual budgets into a master budget** – Each component of the master budget is accumulated from a smaller budget and is then sent to the budget committee who compiles totals into the final master budget. The budget is then handed to senior leadership and accountants for review for any amendments to be made before final approval
- **Approval of the master budget** – the master budget will be approved once it meets the expectations of executives. After completion the budget can still aid the financial department to track and manage cash flow.

2.3.3 Four Behaviours for Management to Consider When Introducing Flexible and Master Budget Systems

Performance Measurement

As flexible budget restructures itself based on the levels of activities it is a great tool for evaluating managers as the budget should align to the expectations at any levels of activity (Accounting Tools, 2022). According to Drury (2021), people perform better when they have clearly defined goal to aim for and are aware of the standards that will be used to interpret their performance. Flexible budgeting allows managers to plan and forecast more accurately hence making performance management more meaningful as actual results can be easily compared however management should consider high levels of indirect cost that may be incurred proving it difficult to differentiate fixed/variable costs from total indirect costs (ACCA, 2023).

Budgeting Efficiency

As flexible budgeting can be readily available to update for activities not yet undertaken and as managers give their approval for the fixed activities and variable expenses the flexible budget can appear to be an excellent way to resolve difficulties inherent in a static budget. However, there are points management should consider such as the difficulty to formulate and administer. One issue with the formulation is that many costs are not fully variable and are fixed that must be calculated in the budget formula. Also,

there will be a great amount of time spent in developing cost formulas which typically budgeting staff do not have (Accounting Tools 2022).

Key performance indicators

If a team's job performance relies on their ability to work within the master budget on a personal level than it may affect their behaviour. Decisions may be taken on what is best for the budget rather than the department. This can lead to cost estimates higher, and sales estimates lower to ensure the goals are reached. Budget adherence can encourage employees to avoid risk that may affect the business. It is suggested to use other key performance indicators to measure success within the team such as absenteeism rate, subjective appraisal and feedback (Indeed, 2023).

Preparation of supporting budgets

The projected financial budget relies on several items in the projected income statement. The logical starting point in preparation is the projected operating budget. But since the planned operating budget demonstrates the net effect of several interrelated activities, management should ensure the preparation of several supporting budgets such as purchases, sales and production before preparation of the operating budget (Hermanson et al. (2018).

2.4 Traditional Approaches to Budgeting in the Context of a Fast- Changing Business Environment

For a business to sustain in the modern world budget system technologies must rapidly be reviewed to optimise financial resources in terms of planning and control. The purpose is to generate a system to enhance performance in the running of the individual departments (Aydin, 2017). According to ICAEU (2023) traditional budgeting involves a budget from the bottom up which starts from projected sales and any directed costs from the sales and then the overheads. For smaller businesses this system works well as people involved are close to what is happening in real-time. However, for larger businesses where there are multiple units there are processes whereby the bottom-up budget is presented to the management who often come back seeking improvements. As both sides are familiar with the process the initial budget has flaws in it. A traditional budget is described as quantitative statement and a useful tool for planning which usually involves goals relating to cash flow,

revenues and liabilities for a certain period (Dropkin et al. 2007 and Horngren et al. 2012). Traditional budgets are prepared by the addition of incremental amounts for instance planned increases and inflation in costs and sales prices to the current yearly budget (ACCA, 2014 and Wildavsky, 1978, pp. 501-509). Traditional budgeting is vital for value-creation and the sustainability of businesses and boasts advantages such as forecasting and future planning, enhance communication, motivation, coordination and facilitation of performance reviews and pricing decisions (Joshi et al. 2003; Oak and Schmidgall, 2009). Although the benefits of traditional budgeting are widespread some businesses are dissatisfied with the barriers of the traditional practices (Ekholm and Wallin, 2000). Research suggested that 80% of businesses were not pleased with their budgeting processes. One of the drawbacks of traditional budgeting is that it is time consuming. Neely et al. (2003) further identified the following weaknesses in three categories:

Competitive Strategy -

- Budgets are not often strategically focused and are contradictory
- Budgets are of little value and tend to be bureaucratic which hinders creative thinking
- Budgets are not concentrated on value creation but rather on cost reduction
- Budgets are constrained in terms of flexibility and to response which often create a barrier to change

Budget Process-

- Budgets are costly to arrange and are time consuming
- Budgets are based on guesswork and unsupported assumptions
- Budgets are developed infrequently (annually)

Organisational Capability

- Budgets enforce departmental barriers rather than sharing of knowledge
- Budgets are not a reflection of the emerging network structures that organisations are adopting
- Budgets strengthen vertical control and command
- Budgets lead to people feeling undervalued

(Neely et al. 2003, p.23).

2.4.1 Alternate Approaches to Traditional Budgetary

The two main approaches that can be adopted to eliminate weaknesses associated with traditional budgeting are better budgeting and beyond budgeting. Better budgeting is focused on enhancing the budgeting process and solves the issues of traditional budgeting and beyond budgeting relies on radical changes to the budgeting process and focus is placed on performance management problems of traditional budgeting.

Better Budgeting

One of the components of better budgeting is activity-based budgeting (ABB). This approach relies on cost driver data to set budgets. Advantages include drawing attention to overhead costs which make up most of the total overhead costs and it recognises the activities that drive costs. However, disadvantages include the time it takes to identify the activities and proves difficult to identify responsibilities for individual activities (Future Learn, 2023).

Beyond Budgeting

According to Hope and Fraser (2003) beyond budgeting is a series of leading principles which facilitate the decentralisation of businesses' decision-making mechanisms and manage the performance without the implications of traditional budgets. Hope and Fraser (2003) state that if businesses perform principles of beyond budgeting well then, they can reach two peaks as being adaptive and decentralised organisations.

2.4.2 Is Traditional Budgeting Useful in Today's Business Environment?

Traditional Budgeting is still regarded as popular for planning and performance management control tool (Libby and Lindsay, 2010). In reality many company cultures and management mentalities align with traditional budgeting and the focus is on the elimination of weaknesses of traditional budgeting as many managements believe they can control, coordinate and communicate to subsections more efficiently via traditional budgets without sharing authority with the subsections (Dugdale and Lyne, 2006). Libby and Lindsay (2010) do champion successful businesses eliminate their weaknesses by performing different budgeting approaches together as general expectations have pivoted towards value creation to suit today's environment.

3.0 Conclusion

In conclusion to the report the author has taken the view that there are many reasons to why an overdraft can be deemed useful to a business as overdrafts offers many short-term solutions. However, the author recognises the threat posed by overdrafts. This can be overcome if running into difficulties with an open and honest discussion with the involved bank. It is vital for Neural LTD to ensure all essential bills are covered before taking on the repayment of the overdraft. Revaluating other costs such as the renovation costs will allow for money to be redistributed to the overdraft as renovations are not deemed essential. Similarly, cutting administration costs by adopting cost saving strategies will allow for more savings. Identifying direct and indirect costs and differentiating them will be useful in preparation for managing the finances. A flexible budget approach is a great way to assess whether overhead cost is under control but can pose difficulty for large, scaled businesses who offer several products and services. Flexible budget can be adjusted to reflect the variances in uncontrollable factors that were unforeseen. It is important to take into consideration the variability of costs such as activity levels in relation to budgeted costs. The master budget will be made by senior managements with many variations before one is finalised and by acquiring an efficient budgeting software will minimise errors. Traditional budgeting is built from the bottom up starting with projected sales, direct costs from sales and overheads. This strategy works well in smaller businesses however for larger companies the budget always seeks improvements. The author has determined that even though there are many budgeting systems such as better budgeting and beyond budgeting which both make for alternative solutions, the fundamental principles of traditional budgeting works well within any organisational setting where there is an implementation of a combination of other budgetary systems where the traditional budgeting lacks.

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5.0 Appendices

Appendix 1

- Formula for total of stock purchased

Stock level + sales income =

Example for June $105 + 180 = 285$

- Formula cost of stock sold

Cost of stock sold (60%)

Sales income $230 \times 60\% = 138$

- Formula for closing stock

Total – sales income =

$285 - 138 = 147$

- Formula sales net

$230 \times 0.3 \times 3 = 2.07$

$$230 - 2.07 = 227.93 \text{ (228)}$$

- Formula for admin

Admin – depreciation (£7,000)

$$26 (7) = 19$$

- Formula for profit and loss

Sales total + June to Nov =

- Formula for cost of goods

Sales total x 60%

- Formula gross profit

30% x sales total

- Formula for selling goods

June to Nov 6-month period add up all

- Formula for admin

June to Nov 6-month period add up all (don't minus depreciation cost)

- Formula for credit charges

Sales x 30% x 3% =

- Formula for operating profit

Gross profit – selling expenses – admin expenses – interest payable =

- Formula for interest payable

6-month x 1000x20%=

- Formula for profit for the period

Operating profit – interest payable =

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