

Master Budget and Responsibility Accounting
Chapter 6

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Budgeting

⚡ the most widely used accounting tool for planning and controlling organizations.

A budget is the

- quantitative expression of a proposed plan of action
- for a future time period and
- an aid to the coordination and implementation of the plan.

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Master Budget?

⚡ a comprehensive expression of management's operating and financial plans for a future time period (usually one year).

⚡ is also summarized in a set of budgeted financial statements.

Pro forma statements

Term used for budgeted financial statements

Income Statement, Balance Sheet and Cash Flow Statement

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The Master Budget

❖ embraces the impact of both *operating* decisions and *financing* decisions.

❖ Operating decisions

center on the use of scarce resources.

❖ Financing decisions

center on how to obtain the funds to acquire those resources.

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Scarce resources

Two Products	X1	X2
Selling Price	\$12.00	\$21.00
Variable Costs	\$8.00	\$18.00
Contribution margin	\$4.00	\$3.00

Machine time (minutes) 10 6

If the firm has scarce machine capacity, which product should be made ?

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Why Budgets?

❖ it gives senior management something to do with all their free time.

❖ it allows the company to make decisions by the seat of its pants.

❖ it causes disruptions because production is uninformed regarding the sales plans of the company



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Why Budgets?

Budgets

- ❖ compel planning, including the implementation of plans.
- ❖ provide performance criteria.
- ❖ promote coordination and communication within the organization

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Performance measures

Choices:

Past performance or
Budgets.

Budgeted performance measures can overcome three key limitations of using past performance:

- ❖ Past results incorporate past miscues and sub-standard performance.
- ❖ The future may be expected to be very different from the past.
- ❖ Managers playing games - ratcheting

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Budgets - Coordination

- ❖ Coordination is the meshing and balancing of all factors of production or service and of all the departments and business functions so that the company can meet its objectives.
- ❖ Communication is getting those objectives understood and accepted by all the employees in the various departments and functions.

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1. Operating budget

Revenue/Sales budget - Units to be sold
Production budget in units - Units to be produced
Direct materials purchase budget
Direct labor budget
Indirect Costs budget
Cost of goods sold budget
Nonmanufacturing costs budget

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2. Financial Budget

Budgeted Income Statement
Financial budget
Capital budget
Cash budget
Budgeted balance sheet
Budgeted statement of cash flows

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Budgets – Strategy and Plans

- ❖ Budgeting is most useful when done as an integral part of an organization's strategy analysis.
- ❖ Strategy describes how an organization matches its own capabilities with the opportunities in the market place to accomplish its overall objectives.

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Budgeting Cycle

- ❖ Planning the performance of the organization
- ❖ Providing a frame of reference, a set of specific expectations against which actual results can be compared
- ❖ Investigating variations from plans
- ❖ Correcting action follows, if necessary
- ❖ Planning again

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Time Coverage of Budgets

- ❖ Budgets typically have a set time period (month, quarter, year).
- ❖ This time period can itself be broken into sub-periods.
- ❖ The most frequently used budget period is one year.
- ❖ Businesses are increasingly using rolling budgets.

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Operating Budget

- ❖ The foundation of the operating budget is the revenue or sales budget.
- ❖ The operating budget ends with the budgeted income statement.

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Responsibility Accounting

It is a system for evaluating the performance of managers based on activities under their supervision.
What is a Responsibility Center?

It is any part, segment, or subunit of a business that needs control.

Could be Production, Sales or Service centers

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Types of Responsibility Centers

Cost center reports
only costs

Revenue center reports
only revenues.

Profit center reports
net income or net loss.

Investment center reports
income or loss and the investment used by the center.

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Feedback and Filing Blame

Budgets coupled with responsibility accounting provide systematic help for managers, particularly if managers interpret the feedback carefully.

$$\text{Variance} = \text{Actual results} - \text{Budgeted figures}$$

How should managers use variances?

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What is Controllability?

It is the degree of influence that a specific manager has over costs, revenues, or other items in question. A controllable cost is any cost that is primarily subject to the influence of a given *responsibility center manager* for a given *time period*.

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