



# APPLIED MANAGEMENT ACCOUNTING

TUTORIAL



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AUBREY PENNING





# Applied Management Accounting

Tutorial

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# 1

# Preparing budgets

## this chapter covers...

*In this chapter we begin our examination of the preparation of budgets.*

*We start by learning the purposes of budgets, and see how some organisations view particular purposes as more important than others. We examine how budget setting links with the organisation's objectives and strategy, and must be built around the key (or principal) budget factor – which is often sales.*

*Next we examine the various budgets that are usually prepared, and how they are sequenced. The key budget factor is normally forecast first, and the other budgets are based around this important data.*

*We then go on to examine the organisation of the budgeting process and the various roles of the budget committee and how individuals can participate. This leads us to an examination of responsibility accounting, and how it fits into budgeting. Next, we discuss some specific techniques that can be used to develop budgets.*

*We then move on to the numerical work involved in creating the budgets connected with a manufacturing organisation and how they fit together, including the master operating budget and the cash budget.*

## INTRODUCTION

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In this book we are going to study the L4 unit 'Applied Management Accounting'. The book will generally follow the order of the learning outcomes in the specification. This is the order of study that is recommended by the AAT. The first topics that we will consider relate to budgeting, and these are covered in the first two chapters in the book.

## THE PURPOSES OF BUDGETS

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**A budget is a financial plan for an organisation, prepared in advance.**

In any organisation the budget provides the mechanism by which the objectives of the organisation can be achieved. In this way it forms a link between the current position and the position that the organisation's managers are aiming for. By using a budget firstly to plan and then to monitor, the managers can ensure that the organisation's progress is coordinated to achieve the objectives of the organisation. The specific purposes and benefits of using budgets are as follows.

### **1 the budget compels planning**

By formalising the agreed objectives of the organisation through a budget preparation system, an organisation can ensure that its plans are achievable. It will be able to decide what resources are required to produce the desired outputs, and to make sure that they will be available at the right time.

### **2 the budget communicates and coordinates**

Because a budget will be agreed by an organisation, all the relevant personnel will be working towards the same ends. During the budget setting process any anticipated problems should be resolved and any areas of potential confusion clarified. All the organisation's departments should be in a position to play their part in achieving the overall goals. This objective of all parts of the organisation working towards the same ends is sometimes referred to as **goal congruence**.

### **3 the budget can be used to authorise**

For organisations where control of activities is deemed to be a high priority the budget can be used as the primary tool to ensure conformity to agreed plans. Once the budget is agreed it can effectively become the authority to follow a particular course of action or spend a certain amount of money. Public sector organisations, with their necessary emphasis on strict accountability, will tend to take this approach, as will some commercial organisations that choose not to delegate too much authority.

#### **4 the budget can be used to monitor and control**

An important reason for producing a budget is that management is able to monitor the actual results against the budget. This is so that action can be taken to modify the operation of the organisation as time passes, or possibly to change the budget if it becomes unachievable. This is similar to the way that standard costing is used to monitor and control costs, and can be used alongside that technique, as we will see later in this book.

#### **5 the budget can be used to motivate**

A budget can be part of the organisation's techniques for motivating managers and other staff to achieve the organisation's objectives. The extent to which this happens will depend on how the budget is agreed and set, and whether it is perceived as fair and achievable. The budget may also be linked to rewards (for example bonuses) where targets are met or exceeded.

### **THE BUDGET CYCLE**

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The budget cycle can be used to describe the various processes that need to be undertaken to implement a budget. They are carried out in the order shown, and generally apply to both large and small businesses, as well as public authorities. You may come across slightly different terminology used in relation to the budget cycle.

#### ■ **budget preparation**

This involves bringing together the various data that is required. It also means making sure that all the relevant people are involved. There are many decisions that will have to be made by the participants, and these issues will be examined more fully as we progress through this section of the book.

#### ■ **budget approval**

For a large organisation, this will be a formal procedure as we will see later. For a small business, it could be an agreement by the relevant managers.

#### ■ **budget implementation**

This means that the budget is active from the start of the budget period. All relevant procedures must be adhered to, and the responsibility and authority as detailed in the budget will be followed.

- **monitoring and evaluation of the budget**

This is a crucial step, and for many organisations is a main reason for budgeting. The budget should be compared with actual performance, and the results reported and acted upon. This can lead to changes to activities, or possibly revision of the current or future budgets.

## THE MAIN TYPES OF BUDGET

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Here we will briefly mention the main types of budget that you need to be familiar with. We will go into further detail regarding each type as we progress through our studies.

- **operating budget**

An operating budget is a short to medium term budget (for example covering a year). It deals with the immediate requirements of the organisation, and it provides the initial steps towards the long-term strategic budget. We will examine the preparation and use of operating budgets thoroughly in our studies.

- **capital budget**

This budget deals with the acquisition (and possibly disposal) of the non-current assets that are required to support the organisation. This budget differs from the operating budget (which is a revenue budget), since it is concerned with 'one-off' transactions.

- **fixed budget**

A fixed budget is one that assumes a certain level of outputs – often sales. The budget is then built around this output level. This type of budget is appropriate if the output level can be forecast with a degree of accuracy – for example if there are sales contracts already in place. Even if there is uncertainty over the forecast output level, a fixed budget can be used for planning purposes, in combination with a flexed budget for monitoring and control.

- **flexed budget**

A flexed (or flexible) budget is one where the **actual output** (for example sales) is used as a basis for the budget. This is carried out by using knowledge of cost behaviour to adjust the budgeted costs in the original fixed budget into line with the actual output. This would be carried out after actual output is known. An alternative would be to produce a series of budgets in advance to cope with a range of possible output levels. We will practise preparing flexed budgets later in this book.

## THE INITIAL STEPS IN BUDGET PREPARATION

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### the aims of an organisation

Before an organisation's managers can begin to build a useful budget there are several initial steps that must be taken. These are based around the fundamental questions about the **aims** – the 'vision' – of the organisation:

*'where do we want it to go?' and  
'how do we get it there?'*

These are essentially long-term issues, and once agreed upon would not tend to be changed very often.

### objectives and strategy

For a budget to be of use to an organisation it must be a mechanism of helping the organisation achieve its **objectives**. The objectives are the targets that the managers of the organisation wish it to achieve. The way in which these objectives are expressed will depend upon the type of organisation and the way in which it operates. For example, a pet food manufacturer may have the specific objective of obtaining sales penetration of 25% of the UK dog food market, whereas an independent TV production company may have the objective of achieving a certain number of viewers on average.

The organisation must then develop a **strategy** for achieving those objectives. Several alternatives may need to be considered before the final strategy is decided upon. The pet food company mentioned in the above example may decide that it needs to develop and market a new food product for young dogs to help it to achieve its objective. The independent TV production company may have a strategy of producing pilots for ten new programmes each year from which it can then develop the most promising.

### relevant data

Before any progress can be made in preparing a budget, relevant data must be identified and collected. We have already seen that information must be available about the aims, objectives and strategy of the organisation so that the budget that is prepared will be consistent with these. The following are examples of the types of data that can be used in developing the budget. The data is divided into data from internal and external sources.

### data from internal sources

#### ■ accounting information

This will include information about the accounting system (eg specific accounting policies) and how they will affect the budget, as well as data collected through the accounting system (for example historical costs).

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- **wage and salary information**

The resource of labour is clearly fundamental to many organisations, and sufficient information must be available to incorporate as appropriate.

### **data from external sources**

- **information about suppliers and availability of inputs**

Information must be available about suppliers' ability to supply the inputs required by the organisation, as well as data about relevant prices. This issue may be relevant to the consideration of limiting factors and can also force revisions to the budget.

- **information about customers and markets**

It would not make sense to plan to make goods or provide services that were not required in the market place. Information of this type is fundamental to developing valid budgets.

- **general economic information**

The impact of the economy on projections is discussed later in this chapter. No organisation can exist in a vacuum and those preparing budgets must recognise the importance of the health of the economy in which they operate.

Information from all these areas will be needed at various points in the budgeting process that is described in this chapter and the next.

### **limiting factors – the 'key' budget factor**

When an organisation prepares a budget, it must first analyse its **limiting factors** – the issues that determine the level of its output. For a commercial organisation these could include:

- the size of its market
- the capacity of its premises
- the availability of raw material
- the amount of working capital
- the availability of skilled workers

One of the factors will be the main one that affects the activity level of the organisation – **the key budget factor**. This is the factor (sometimes known as the 'principal budget factor') that all the aspects of the operation depend upon. For most manufacturing or trading operations the key budget factor is **sales**; the assumptions that are made about the level of sales in the budget will affect all the other parts of the budget. This is because the organisation will plan to support the budgeted sales level and build the budgets and assumptions around this one factor.

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Although sales level is the most common key factor, some commercial organisations may decide that a different factor is the most important in their particular circumstances. For example, if a manufacturer can sell all that it produces, but has production restricted by lack of skilled labour, then the assumed labour level would become the key budget factor. A similar situation would arise if there were production restrictions caused by shortages of raw materials, or limited machine capacity.

Non-commercial organisations will also need to identify their key budget factor, and build their budgets around their assumptions concerning it. Charities and government agencies may consider that there is a demand for their services that is virtually limitless; their principal (key) budget factor is the amount of money they receive to fund what they do. For example, the Government's healthcare provision is limited by the amount of funding it can get from the government spending allocation and from private enterprise. The demand for Oxfam's aid is very high, but its key budget factor is the amount of money it can expect to raise to fund that aid.

There may be times when a limiting factor changes during a budget period as a result of changing demand or availability of resources. The issues of dealing with limited materials, labour and production capacity are examined later in this book.

### **the initial budgeting process**

If we combine the ideas just discussed then the initial budget process for an established organisation would follow the pattern in the following diagram:

