OPERATING BUDGET – THEORY AND PRACTICE

Lecturer Ph.D., Cristina Aurora BUNEA-BONTAȘ
”Constantin Brancoveanu” University of Pitesti, Romania
Faculty of Management Marketing in Economic Affairs of Braila
E-mail: bontasc@yahoo.com

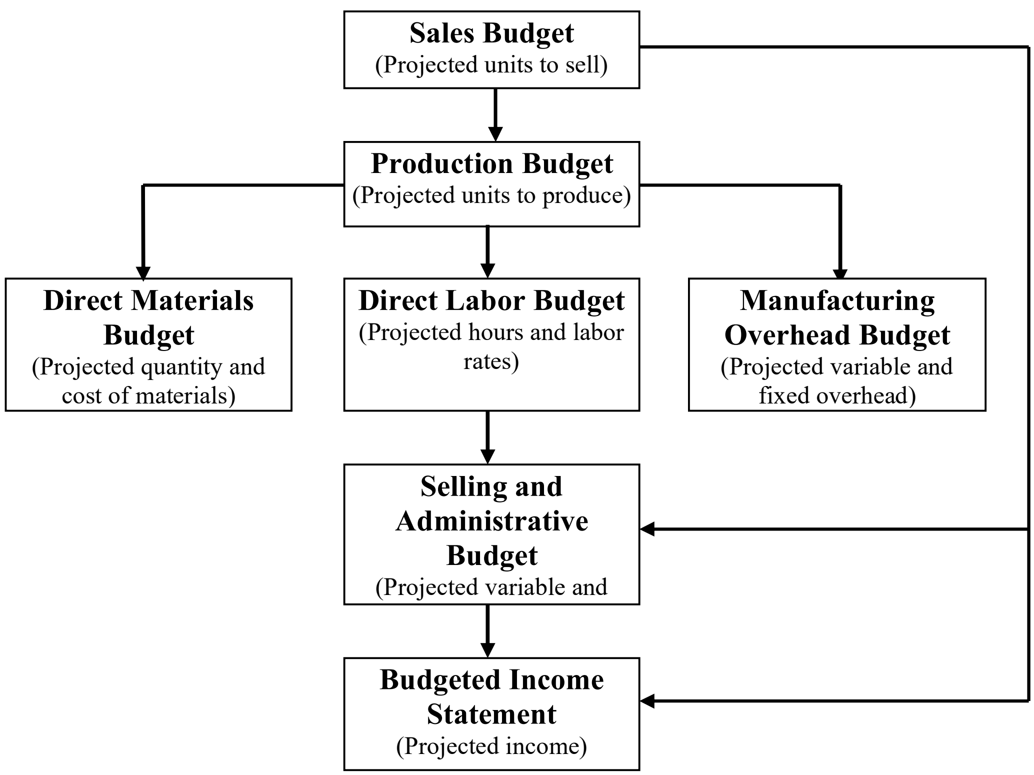
Abstract: *A predictive management involves the planning and budgeting of the company's main activities and the control of compliance with the budget provisions, which makes the budget the main component of management control. Throughout the company's activity, no matter how perfect the company's strategy is, a control of forecasts is necessary in order to detect the causes that lead to the appearance of deviations, establish responsibilities and provide the necessary corrective measures. This article aims to present the operating budget of the company, its structure and the stages of the budgeting process. The advantages and disadvantages of using the operating budget as a predictive management tool are also emphasized.*

Keywords: *budget, operating budget, sales budget, production budget, production cost budget.*
JEL Classification: *M41.*

1. Introduction

The operating budget helps companies in planning future revenue, expenses and results in a projected income statement. The operating budget has several subsidiary budgets that begin with projected sales. Management uses the number of units from the sales budget to determine the quantity of units needed to be produced. This information is used in the production budget. The production budget is then divided into budgets for materials, labor, and overhead.

Figure no. 1. The structure of the operating budget



Sourse: Adapted from Graybeal P., Franklin M., Cooper D., 2019. *Principles of Accounting, Volume 2: Managerial Accounting*, Rice University, p. 355

Based on the information from the operating budget, the company's management should be able:

- to optimize the production process, taking into account limited availability of resources;
- to assess whether additional resources are needed in the following period;
- to determine the forecasted production cost of each product whose manufacture is planned during the budget period;
- to use the information on the production cost for the purpose of reporting the forecasted financial results;
- to prepare the forecast of cash flows, in terms of payments of suppliers and contractors, employees and other organizations and persons, who provide necessary services for the production activity.

2. Sales budget

In the market economy, the turnover represents the most important indicator of the economic activity of the company, because production, supply, the number and structure of the employed personnel and the necessary investments are determined according to sales.

The following steps are associated with preparing the sales budget:

1. determine the unit level of sales, broken down, if appropriate, by product, geographical area, market segment and/or period,
2. determine the unit selling price for each product, considering also the commercial discounts,
3. multiply the unit quantities by the unit prices and calculate the total units and the total sales for each category and as a whole.

Preparation of the sales budget should take into consideration some uncontrollable factors that might include:

- general economic trends, industry trends and specific market factors,
- interest rates and inflation,
- public policies and legal regulations,
- political conditions and global and regional events,
- actions of competitors, including new products and new manufacturing technology,
- availability of supplies and supplier action.

3. Production budget

The production budget estimates the number of units of each product that will have to be manufactured to achieve the anticipated sales. This budget is stated in units of the product or the quantity.

The preparation of the production budget involves:

- processing the information from the sales budget regarding the quantities of products to be manufactured (production schedule),
- dividing by quarters/months the quantities of forecasted products,
- estimation of the total production volume.

The production budget is an important part of the company's inventory control. If there is an accurate production budget, the business won't stock out of its product and it will also not hold outdated inventory since the quantity of the manufactured products is based on the sales forecast.

4. Production cost budget

The production cost budget provides a detailed overview of the estimated cost of carrying out the production plans as per the production budget. It represents the cost of various elements involved in production, such as materials, labor, and overheads.

The production cost budget includes:

a) The direct materials budget is calculated on the basis of the standard consumption established for every type of raw materials, separately for each product to be manufactured, the standard unit prices of materials and the production schedule of the budgeted period.

The direct materials budget uses the standard quantity and standard price for raw materials that need to be purchased.

This budget helps purchasing department to prepare purchase schedule to enable uninterrupted delivery of materials for production. It also helps finance managers to determine finances required to meet the production targets. Thus, this budget helps in managing cash flows in a better way as it notifies the exact amount and timing of the expected cash flow required in the future.

b) The direct labor budget is determined by analytical calculation for each manufactured product, using the number of labor hours, wage rates per time unit and the production schedule of the budgeted period.

The direct labor budget uses the standard direct labor rate and the standard direct labor hours that need to be scheduled.

This budget helps management to identify labor shortages and make necessary adjustments in order to avoid any production disruption.

c) The manufacturing overhead budget includes the remainder of the production costs not covered by the direct materials and direct labor budgets. Some examples of manufacturing overhead costs include the following:

- wages for managers and supervisors in the manufacturing facilities,
- depreciation on the manufacturing equipment,
- depreciation, rent and property taxes on the manufacturing facilities,
- repairs and maintenance for the manufacturing equipment,
- workplace health and safety, protective equipment and all associated costs,
- electricity and gas used in the manufacturing facilities,
- indirect factory supplies.

Because manufacturing overhead is an indirect cost, accountants are faced with the task of allocating overhead costs to each of the units produced. In the budgeting process, overhead costs are typically allocated depending upon their cost behavior production characteristics, which are generally classified as either variable or fixed. Based on this allocation process, the variable components are treated as occurring proportionately in relation to budgeted activity, while the fixed components are treated as remaining constant.

The allocation process may be a challenging task because there may be no direct relationship between the expense need to be allocated and the units produced. For example, the property taxes and insurance on the manufacturing buildings are based on the assets' value and not on the number of units manufactured.

A practical approach for preparing the material, labor and overhead, is using the historic quantities of the amount of material per unit and the hours of direct labor per unit to compute a standard used to estimate the quantity of materials and labor hours needed for the expected level of production. Current costs are used to develop standard costs for the price of materials, the direct labor rate, as well as an estimate of overhead costs.

5. Selling and Administrative Budget

The information in this budget is not directly derived from any other budgets.

In a practical approach, the amounts budgeted are based on the most recent budget or the most recent actual results.

An important aspect that should not be neglected is the forecast of sales expenses. These can be separated into variable expenses (packaging, distributors' salaries, commissions, and transport expenses) and fixed expenses (electricity and gas for warehouses, rent, depreciation, market studies, and advertising).

Administrative expenses refer to the costs incurred by a company that include, but are not limited to, the salaries and benefits of the administrative workers within the company, as well as rent and managerial compensation.

Once the operating budget is set and it begins to be applied, the company's activity should be controlled and its results should be verified to detect the degree to which expectations are being met. Through budget control, the actual data are compared with the budgeted data, and verify achievements, as well as correct differences. This process requires tools that allow deviations to be detected in time to be able to make the right decisions that correct the direction of the company's plan and is also capable of:

- integrate actual data and budgets in the same database,
- correct budget based on variance analysis using forecast calculations,
- generate early alerts of deviations through notifications,
- performing monthly, quarterly and annual analyses.

6. Conclusions

To achieve the proposed goals, well-managed companies plan their economic activities and allocated resources. The planning process using the operational budget has the following advantages:

- the assessment of the efficiency of the actions undertaken in terms of controllable revenue/expenses;
- making optimal decisions regarding the activity in the future, based on the comparison of the planned indicators with the actual ones;
- managing expenses through the optimal allocation of resources;
- the existence of a communication channel between managers and subdivisions, with efforts directed towards achieving the planned objectives;
- setting of an efficient accounting information system that provides necessary information especially for internal users;
- constraining the managers of the responsibility centers to foresee the consequences of their decisions, the budgets being a reference tool in decision-making;
- the participation in the planning activity of both the management and the executive staff.

An efficient budgetary system has a positive impact on the ability of the management to anticipate and respond with articulated measures to opportunities and pressures from the environment in which the company operates. The budgets are interactive tools between different levels of management, assuring an open dialogue within a company, this insuring the company's survival in a changing business environment, such as the present one.

There are several disadvantages associated with the use of operating budgeting within a business.

Time-consuming: The budgeting process may be very time-consuming, especially in a poorly-organized environment where many iterations of the budget may be required.

Also monitoring the budget can be time-consuming and may take away from other important tasks.

Inflexibility: The operating budget can be inflexible and may not allow the adjustment to some unexpected changes in circumstances, this leading to missed opportunities. If there are changes in the market environment during the budget year, the company should shift along with the market, rather than sticking to the budget.

Unrealistic targets: The targets set in the operating budget must be attainable, based on the company's history, the available resources as well as economic and industry trends. If targets are set too high, employees will perceive the budget as unachievable and they will likely become discouraged.

Consider only financial outcomes: The expected revenue is estimated to cover expenses of the year, however production and cost fluctuations, as well as slow-paying clients and uncollectible accounts receivable, can lead to temporary cash shortages.

Potential source for internal conflicts: A budget can create competition among staff and between departments. If a department does not achieve its budgeted results, other departments may be blamed. This may lead to conflicts and lack of teamwork and collaboration.

Other disadvantages, such as rigidity or complexity can be added to those previously mentioned.

In conclusion, budgeting can be a valuable tool and operating budget allows managers to plan ahead, allocate resources effectively, and improve communication and coordination. However, it's important to be aware of the potential disadvantages, which can be overcome by periodically updating the operating budget. The budget is dynamic and should change based on periodic reviews.

References:

1. Accounting Coach, 2023. *What is manufacturing overhead and what does is include?* [online] Available at: <https://www.accountingcoach.com/blog/what-is-manufacturing-overhead-and-what-is-included> [Accessed 20 March 2023].
2. Accounting Tools, 2023. *Selling and administrative expense budget*. [online] Available at: <https://www.accountingtools.com/articles/selling-and-administrative-expense-budget> [Accessed 20 March 2023].
3. Accounting Tools, 2023. *The disadvantages of budgeting.* [online] Available at: <https://www.accountingtools.com/articles/what-are-the-disadvantages-of-budgeting.html> [Accessed 20 March 2023].
4. Bajan, M. and Sîrbu, M., 2000. *Organizarea si Controlul Executării Bugetului Operațional / Formation and Control of Operating Budget*. [online] Available at: <https://irek.ase.md/xmlui/bitstream/handle/1234567890/590/Bajan_M_Sirbu_M_%20conf_12.03.20.pdf?sequence=1&isAllowed=y> [Accessed 20 March 2023].
5. Briciu, S., 2006. *Contabilitatea manageriala. Aspecte teoretice si practice*. Bucharest: Economica Publishing House.
6. Clowes, R. and Scriven, V., 2011. *Budgeting: a practical approach / National Institute of Accountants*. 2nd Edition. Pearson Australia. [online] Available at: <https://books.google.ro/books?id=qAfiBAAAQBAJ&pg=PA24&hl=ro&source=gbs_toc_r&cad=3#v=onepage&q&f=false> [Accessed 20 March 2023].
7. Epuran, M., Băbăiță, V. and Grosu, C., 1999. *Contabilitate și control de gestiune*. Bucharest: Economica Publishing House.

8. Finance Management, 2021. *Direct Materials Budget: meaning, components, format, advantages and variance analysis.* [online] Available at: <https://efinancemanagement.com/budgeting/direct-materials-budget> [Accessed 20 March 2023].
9. Graybeal, P., Franklin, M. and Cooper, D., 2019. *Principles of Accounting, Volume 2: Managerial Accounting*. Rice University. [online] Available at: <https://assets.openstax.org/oscms-prodcms/media/documents/ManagerialAccounting-OP_x3x7rSO.pdf> [Accessed 20 March 2023].
10. Pintea, M.O., Lacatus, V.D. and Deceanu, L.D., 2013. *Purpose for Budgeting – Literature Review.* [online] Available at: <https://conferinta2013.academiacomerciala.ro/_VOLCONF2013PDF/volumconferinta/PURPOSE%20FOR%20BUDGETING%20-%20LITERATURE%20REVIEW_pintea.pdf> [Accessed 20 March 2023].