CAMBRIDGE

Study & Master

Support Pack | Grade 12

CAPS

Accounting

Budgeting

This revision pack for **Accounting Grade 12** provides support for learners revising the most important concepts and principles covered in the CAPS curriculum. These include concepts relating to companies, the acquisition of Fixed assets, inventories, VAT, Manufacturing and cost accounts, and budgeting. Summaries of the GAAP principles, theory of Accounting, and the format of Debtors and Creditors control accounts are provided. Furthermore, a detailed table to summarise the interpretation of Financial Statements is provided.

Cambridge University Press Africa is a proudly South African publisher – we are providing this material in response to the need to support teachers and learners during the school shutdown and for the remainder of the 2020 school year.

For more information on our *Study & Master* CAPS-approved textbooks and valuable resource material, visit ***www.cambridge.org***

We are all in this together!

www.cambridge.org

Revision 10
Budgeting

1. Fundamental budgeting concepts

- **Budget:** A written financial plan that is prepared for a future period
- **Budget period:** The period of time over which the budget is drawn up

Budgets generally cover one of three periods of time:

- **Short-term budgets:** usually less than one year
- **Medium-term budgets:** usually one year (12 months)
- **Long-term budgets:** usually prepared for a number of years

- **Operating budget:** Consists of the various budgets that relate to the **income** and **expenses** of a business. These include the Sales Budget, Cost of Sales Budget and Operating Expenses Budget, which are combined to form the **Projected Statement of Comprehensive Income (Projected Income Statement)**.
- **Financial budget:** Consists of the various budgets that relate to the assets and liabilities of a business. These budgets include the **Cash Budget**, the Capital Budget as well as budgets for debtors, creditors and inventory.
- **Budget preparation:** When preparing a budget, management will attempt to plan and forecast the business activities that are required to take place in order to attain the objectives of the business.

While preparing a budget, management should take the following into account in order to ensure that the figures in the budget are realistic:

- Information and accounting records from previous periods
- The objectives and strategies of the business
- Existing business agreements
- Past, current and seasonal trends
- The current and predicted future economic climate
- Other external factors, such as expected petrol price or electricity tariff increases

- **Reasons for budgeting:** Budgeting is an essential tool used by management to plan, monitor and control business activities.

Some of the more important reasons for budgeting:

- **Planning:** Budgets are used by management to plan the future activities of the business. This is arguably the primary purpose of budgeting.
- **Internal control:** Budgets are used by management to monitor and control the activities of the business.
- **Communication:** Budgets allow management to communicate their expectations and the business's objectives to the various departments and employees throughout the business.
- **Motivation:** Budgets and the budgeting process can help to motivate employees.
- **Evaluation:** Budgets are often used by management as a benchmark for evaluating the performance of employees.

2. The Projected Statement of Comprehensive Income (Projected Income Statement)

The Projected Statement of Comprehensive Income (Projected Income Statement) is used to plan, monitor and control the **profitability** of a business. It reflects the **estimated income** and **estimated expenses** over the budget period and is used to plan and forecast the **estimated profit** of a business over the budget period.

> When preparing a Projected Statement of Comprehensive Income (Projected Income Statement), the key word to keep in mind is **profit**.

- **Preparing and presenting the Projected Statement of Comprehensive Income (Projected Income Statement)**
  The Projected Statement of Comprehensive Income (Projected Income Statement) has the same format as the "normal" Statement of Comprehensive Income (Income Statement). However, here the figures relate to **future projections** and **not past results**.
  - The Projected Statement of Comprehensive Income (Projected Income Statement) is usually prepared based on the figures in the **previous year's Statement of Comprehensive Income (Income Statement)**.
  - These figures are then **adjusted** by taking into account any planned or predicted business activities, trends and economic conditions.
  - Since the budget period may span several months or even years, the Projected Statement of Comprehensive Income (Projected Income Statement) often contains **several columns**.

- **Analysing, interpreting and comparing the Projected Statement of Comprehensive Income (Projected Income Statement)**
  The real value of the Projected Statement of Comprehensive Income (Projected Income Statement) lies in the information that it provides and the way in which management uses this information to ensure that the business objectives are achieved.
  - During the **planning stage**, management will analyse and interpret this information to ensure that the business activities are well planned.
  - During the **budget period**, management will compare this information to actual results to ensure that the business activities are well-controlled and carried out according to plan.

Analysing and interpreting during the planning stage

During the planning stage, management will analyse the information in the Projected Statement of Comprehensive Income (Projected Income Statement) in order to ascertain whether:

- the business is expected be profitable during the budget period
- the projected sales figures are satisfactory
- the planned percentage mark-up is adequate
- expenses need to be cut
- the business can afford to pay bonuses, hire additional staff, run an advertising campaign, and so on.

Based on their interpretation of this analysis, management will decide whether they have made the best possible plans for the business or if they need to adjust their plans and look for ways to increase the expected profit.

Analysing, interpreting and comparing during the budget period

During the budget period, management will use the information in Projected Statement of Comprehensive Income (Projected Income Statement) to monitor and control the business operations by comparing the actual figures achieved with the budgeted amounts. The comparative figures will then be carefully analysed, and based on their interpretation of this information, management can assess whether:

- the business is performing to expectations
- corrective action needs to be taken
- they need to investigate further in order to identify underlying problems
- control measures need to implemented or improved
- the budget figures were unrealistic and need to be adjusted in the Projected Statement of Comprehensive Income (Projected Income Statement).

3. The Cash Budget

The Cash Budget is used to plan, monitor and control the **liquidity** of a business. The Cash Budget reflects the **inflow and outflow of cash** over the budget period and is used to forecast and plan the **cash flow** of the business.

When preparing the Cash Budget, the most important word to keep in mind is **cash**.

- **Debtors Collection Schedule and Creditors Payments Schedule**
  The Debtors Collection Schedule and the Creditors Payment Schedule are normally drawn up before the Cash Budget is prepared.
  - The **Debtors Collection Schedule** is used to determine the amount of cash that is expected to be collected from debtors during the budget period.
  - The **Creditors Payment Schedule** sets out the amount of cash that is expected to be paid to creditors during the budget period.

- **Preparing and presenting the Cash Budget**
  Only **future cash transactions** are considered when preparing a Cash Budget.

- Expected **cash inflows** for the budget period are recorded in the **receipts** section of the Cash Budget,
- Expected **cash outflows** for the budget period are recorded in the **payments** section of the Cash Budget.
- The **cash surplus or deficit** for each month is determined by subtracting the total expected payments for the month from the total expected receipts for the month.
- The surplus or deficit is then added to the cash balance at the beginning of the period to determine the expected amount of cash on hand at the end of the period.

- **Analysing, interpreting and comparing Cash Budgets**
  Much of the benefit of the Cash Budget stems from management's ability to analyse and interpret the information it provides to make effective decisions regarding the cash flow of the business.
  - During the planning stage, management will analyse this information and, based on their interpretation of this analysis, will decide whether the business will have sufficient cash resources during the budget period to carry out their intended strategy.
  - During the budget period, management will compare this information to actual results to monitor and control the cash flow of the business.

Analysing and interpreting during the planning stage

During the planning stage, management will analyse and interpret the information in the Cash Budget to ascertain whether the business will have enough cash during the budget period to:

- meet its short-term commitments (such as paying trade creditors and repaying loans)
- purchase stock
- pay operating expenses
- purchase additional fixed assets.

If the Cash Budget of the business predicts a cash shortfall in a specific month, management can make arrangements with the bank or make alternative plans in advance.

Analysing, interpreting and comparing during the budget period

During the budget period, management will use the information in Cash Budget to monitor and control the cash flow of the business by comparing the actual figures achieved with the budgeted amounts. The comparative figures will then be carefully analysed and, based on their interpretation of this information, management can assess whether:

- the business is managing its cash flow as expected
- corrective action needs to be taken to improve liquidity
- they need to investigate further in order to identify underlying cash flow problems
- control measures need to be implemented or improved
- the budget figures were unrealistic and need to be adjusted in the Cash Budget

4. Variance analysis

A variance analysis is a technique commonly used by management to analyse the data when comparing actual figures with the budgeted amounts.

- The differences between actual and budgeted amounts are called *variances*.
- Management will usually draw up a table known as a *Variance Analysis Report*.
- The Variance Analysis Report sets out the budgeted and actual figures for each item in the budget, as well as the variance amount and the variance percentage.

A variance analysis can be used for comparisons involving either the Projected Statement of Comprehensive Income (Projected Income Statement) or the Cash Budget. However, it is important to bear in mind that:

- When performing variance analysis using the **Projected Statement of Comprehensive Income (Projected Income Statement)**, you are comparing actual and budgeted **income** and **expenses.**
- When performing variance analysis using the **Cash Budget**, you are comparing actual and budgeted **cash receipts** and **cash payments.**

Exam tips on answering variance analysis questions

- Calculate the variance = actual amount – budgeted amount
- Calculate the percentage variance = $\frac{\text{actual amount} - \text{budgeted amount}}{\text{budgeted amount}} \times \frac{100}{1}$
- State whether the actual amount is more than or less than the budgeted amount.
- Comment on whether it is a positive or negative result for the business.
- Comment on whether it is significant or insignificant.
- Suggest possible reasons for the variance.
- Suggest steps that should be taken by management (such as corrective action, further investigation, improve controls or adjust unrealistic budget figures).