**LEARNER GUIDE**

**Manage expenditure against a budget**

Unit Standard 242810

Level 4 Credits 6

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PERSONAL INFORMATION

|  |  |
| --- | --- |
| **NAME** |  |
| **CONTACT ADDRESS** |  |
|  |
| **Code** |  |
| **Telephone (H)** |  |
| **Telephone (W)** |  |
| **Cellular** |  |
| **Learner Number** |  |
| **Identity Number** |  |
|  |
| **EMPLOYER** |  |
| **EMPLOYER CONTACT ADDRESS** |  |
|  |
| **Code** |  |
| **Supervisor Name** |  |
| **Supervisor Contact Address** |  |
|  |
| **Code** |  |
| **Telephone (H)** |  |
| **Telephone (W)** |  |
| **Cellular** |  |

INTRODUCTION

#### Welcome to the learning programme

Follow along in the guide as the training practitioner takes you through the material. Make notes and sketches that will help you to understand and remember what you have learnt. Take notes and share information with your colleagues. Important and relevant information and skills are transferred by sharing!



This learning programme is divided into sections. Each section is preceded by a description of the required outcomes and assessment criteria as contained in the unit standards specified by the South African Qualifications Authority. These descriptions will define what you have to know and be able to do in order to be awarded the credits attached to this learning programme. These credits are regarded as building blocks towards achieving a National Qualification upon successful assessment and can never be taken away from you!

Structure

### Programme methodology



The programme methodology includes facilitator presentations, readings, individual activities, group discussions and skill application exercises.

Know what you want to get out of the programme from the beginning and start applying your new skills immediately. Participate as much as possible so that the learning will be interactive and stimulating.

The following principles were applied in designing the course:

* Because the course is designed to maximise interactive learning, you are encouraged and required to participate fully during the group exercises
* As a learner you will be presented with numerous problems and will be required to fully apply your mind to finding solutions to problems before being presented with the course presenter’s solutions to the problems
* Through participation and interaction the learners can learn as much from each other as they do from the course presenter
* Although learners attending the course may have varied degrees of experience in the subject matter, the course is designed to ensure that all delegates complete the course with the same level of understanding
* Because reflection forms an important component of adult learning, some learning resources will be followed by a self-assessment which is designed so that the learner will reflect on the material just completed.

This approach to course construction will ensure that learners first apply their minds to finding solutions to problems before the answers are provided, which will then maximise the learning process which is further strengthened by reflecting on the material covered by means of the self-assessments.

#### Different role players in delivery process

* Learner
* Facilitator
* Assessor
* Moderator

### What Learning Material you should have

This learning material has also been designed to provide the learner with a comprehensive reference guide.

It is important that you take responsibility for your own learning process; this includes taking care of your learner material. You should at all times have the following material with you:

|  |  |
| --- | --- |
| **Learner Guide** | **This learner guide is your valuable possession:**This is your textbook and reference material, which provides you with all the information you will require to meet the exit level outcomes. During contact sessions, your facilitator will use this guide and will facilitate the learning process. During contact sessions a variety of activities will assist you to gain knowledge and skills. Follow along in the guide as the training practitioner takes you through the material. Make notes and sketches that will help you to understand and remember what you have learnt. Take and share information with your colleagues. Important and relevant information and skills are transferred by sharing!This learning programme is divided into sections. Each section is preceded by a description of the required outcomes and assessment criteria as contained in the unit standards specified by the South African Qualifications Authority. These descriptions will define what you have to know and be able to do in order to be awarded the credits attached to this learning programme. These credits are regarded as building blocks towards achieving a National Qualification upon successful assessment and can never be taken away from you! |
| **Formative Assessment Workbook** | The Formative Assessment Workbook supports the Learner Guide and assists you in applying what you have learnt. The formative assessment workbook contains classroom activities that you have to complete in the classroom, during contact sessions either in groups or individually.You are required to complete all activities in the Formative Assessment Workbook. The facilitator will assist, lead and coach you through the process.These activities ensure that you understand the content of the material and that you get an opportunity to test your understanding.  |

### Different types of activities you can expect

To accommodate your learning preferences, a variety of different types of activities are included in the formative and summative assessments. They will assist you to achieve the outcomes (correct results) and should guide you through the learning process, making learning a positive and pleasant experience.



The table below provides you with more information related to the types of activities.

| **Types of Activities** | **Description** | **Purpose** |
| --- | --- | --- |
| **Knowledge Activities** | You are required to complete these activities on your own.  | These activities normally test your understanding and ability to apply the information. |
| **Skills Application Activities** | You need to complete these activities in the workplace  | These activities require you to apply the knowledge and skills gained in the workplace |
| **Natural Occurring Evidence** | You need to collect information and samples of documents from the workplace. | These activities ensure you get the opportunity to learn from experts in the industry.Collecting examples demonstrates how to implement knowledge and skills in a practical way |

### Learner Administration



#### Attendance Register

You are required to sign the Attendance Register every day you attend training sessions facilitated by a facilitator.

#### Programme Evaluation Form

On completion you will be supplied with a “Learning programme Evaluation Form”. You are required to evaluate your experience in attending the programme.

Please complete the form at the end of the programme, as this will assist us in improving our service and programme material. Your assistance is highly appreciated.

### Assessments

The only way to establish whether a learner is competent and has accomplished the specific outcomes is through the assessment process. Assessment involves collecting and interpreting evidence about the learners’ ability to perform a task.

To qualify and receive credits towards your qualification, a registered Assessor will conduct an evaluation and assessment of your portfolio of evidence and competency.

This programme has been aligned to registered unit standards. You will be assessed against the outcomes as stipulated in the unit standard by completing assessments and by compiling a portfolio of evidence that provides proof of your ability to apply the learning to your work situation.



**How will Assessments commence?**

#### Formative Assessments

The assessment process is easy to follow. You will be guided by the Facilitator. Your responsibility is to complete all the activities in the Formative Assessment Workbook and submit it to your facilitator.

#### Summative Assessments

You will be required to complete a series of summative assessments. The Summative Assessment Guide will assist you in identifying the evidence required for final assessment purposes. You will be required to complete these activities on your own time, using real life projects in your workplace or business environment in preparing evidence for your Portfolio of Evidence. Your Facilitator will provide more details in this regard.

To qualify and receive credits towards your qualification, a registered Assessor will conduct an evaluation and assessment of your portfolio of evidence and competency.

### Learner Support

The responsibility of learning rests with you, so be proactive and ask questions and seek assistance and help from your facilitator, if required.



Please remember that this Skills Programme is based on outcomes based education principles which implies the following:

* You are responsible for your own learning – make sure you manage your study, research and workplace time effectively.
* Learning activities are learner driven – make sure you use the Learner Guide and Formative Assessment Workbook in the manner intended, and are familiar with the workplace requirements.
* The Facilitator is there to reasonably assist you during contact, practical and workplace time for this programme – make sure that you have his/her contact details.
* You are responsible for the safekeeping of your completed Formative Assessment Workbook and Workplace Guide
* If you need assistance please contact your facilitator who will gladly assist you.
* If you have any special needs please inform the facilitator

### Learner Expectations

Please prepare the following information. You will then be asked to introduce yourself to the instructor as well as your fellow learners



|  |
| --- |
| Your name:  |
|  |
|  |
| The organisation you represent:  |
|  |
|  |
| Your position in organisation:  |
|  |
|  |
| What do you hope to achieve by attending this course / what are your course expectations? |
|  |
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| Programme Structure And Strategy |
| **UNIT STANDARD 242810 Level 4** |
| **Credits 6: notional hours 60, classroom training 18 hours, workplace hours 42** |
| **Programme Outcomes** | **Page2** | **Outcomes**  | **Time Allocation** | **Delivery strategy** | **EEK** | **CCFO** | **Formative Assessment** | **Summative Assessm: total time 42 hours** |
| PERSONAL INFORMATION | 4 |   | Introductory activities: 60 minutes | Discussion  |  |  |  |  |
| How To Use This Learner Guide | 4 |   |   |   |   |   |
| Programme Overview | 4 |   |   |   |   |   |
| Personal Objectives And Expectations | 5 |   |   |   |   |   |
| **UNIT STANDARD 242810** | 6 |   |   | Discussion & slide show |   |   |   |   |
| **SECTION 1: THE BUDGET** | 8 | SO1 | 245 minutes | N/A | Identify and solve problems  |   | QuestionnaireWorkplace Develop a budget template to use at work, find out what the expenses of your unit are, develop a zero-based budget, determine resources and costs, discuss variances  |
| Budgeting | 9 | AC1 |   |   | Organise and manage  |   |
| Budgetary control | 27 | AC2 |   |   |   |   |
| Budget and expense | 29 |   |   |   |   |   |
| The budget technique | 32 |   |   |   |   |   |
| Formative assessment SO1 AC 1 - 2 | 41 |   | 45 minutes |   | Collect, analyseorganise  | Group activity: Develop a budget |   |
| **SECTION 2: ELEMENTS OF A BUDGET** | 42 | SO2 | 245 minutes |   |   |   |   |
| The Elements Of A Budget | 43 | AC1 |   |   | Work effectively with others  |   | QuestionnaireWorkplace: What internal and external constraints exist on the budget of your department?Explain how variances are identified and reported in your organisation |
| Internal and external constraints on a budget | 45 | AC2 |   |   |   |   |   |
| Formative assessment SO 2 AC 1 - 2 | 55 |   | 45 minutes |   |   | Individual and group activity: Constraints on budget |   |

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **SECTION 3: MONITOR AND CONTROL ACTUAL EXPENSES** | 56 | SO3 | 245 minutes |  |   |   |   |   |
| Monitor and control expenses against a budget | 57 | AC1 |   |   | Communicate |   | QuestionnaireWorkplace:Monitor the actual expenses for your department against your budget for at least three monthsIdentify variances and suggest corrective measures that correspond to the SOP of your organisation |
| Identify variances and take corrective action | 60 | AC2 |   | N/A | Demonstrate an understanding ofthe world as a set of related systems  |   |
| Formative assessment SO3 AC 1 - 2 | 62 |   | 45 minutes |   |   | Group activity: Discuss budgets |
| **Revision**  |  |  | **60 minutes** |   |   |   |   |
| **Summative questionnaire** |  |  | **90 minutes** |   |   |   |   |   |
| **Notional Hours** |  |  | **18** |   |   |   |   | **42** |

# UNIT STANDARD

#### Unit Standard Title

Manage expenditure against a budget

#### NQF Level

4

#### Credits

6

#### Purpose Of The Unit Standard

A Person credited with this unit standard will be able to identify the measures necessary to prevent and manage a crime related incident, and to address personal safety issues and asset security, in order to make any environment more secure for the person and for assets.

This unit standard will be useful to any person who works in a situation where any form of crime related to a person, property or asset is possible.

#### Learning Assumed To Be In Place And Recognition Of Prior Learning

Communication at NQF 1 or equivalent

#### Unit Standard Range

The applied competence expressed in this standard covers the knowledge and understanding of preventing and managing a crime situation, which is necessary for learners who work in the broader South African economy.

The range includes innovative responses to unfamiliar and unpredictable problems, using basic analytical interpretation of information.

The level assigned to this Unit Standard is appropriate because a fairly narrow range of knowledge and cognitive skills is applied.

#### Specific Outcomes and Assessment Criteria:

**Specific outcome 1:** Explain the concept of budgeting pertinent to an area of responsibility.

**Assessment criteria**

* The concept of a budget is explained with reference to expenditure in an area of responsibility.
* The budgeting technique employed is explained by means of worked examples. Budget techniques may include but are not limited to, forecasting, based on historic data, and zero-based budgeting.

**Specific outcome 2:** Determine the elements of a budget in an area of responsibility.

**Assessment criteria**

* The elements of the budget are identified for the resources required to meet the objectives.
* Internal and external constraints on a budget are identified in terms of an own organisational context.

**Specific outcome 3:** Monitor and control actual expenses against a budget.

**Assessment criteria**

* Actual expenses are monitored according to standard operating procedures.
* Variances are identified and corrective measures are proposed and/or taken according to standard operating procedures.

#### Unit Standard Essential Embedded Knowledge

N/A

#### Critical Cross-Field Outcomes

* Learners are able to make decisions in determining the elements of a budget and in monitoring and controlling expenses
* Learners are able to identify variances between actual expenditure and the budget
* Learners are able to communicate effectively in identifying substantiating the internal and external contents of a budget
* Learners are able to demonstrate an understanding of the world as a set of related systems when monitoring and controlling the actual expenses of a budget

# SECTION 1: THE BUDGET

#### Specific outcome

Explain the concept of budgeting pertinent to an area of responsibility

#### Assessment criteria

* The concept of a budget is explained with reference to expenditure in an area of responsibility.
* The budgeting technique employed is explained by means of worked examples. Budget techniques may include but are not limited to, forecasting, based on historic data, and zero-based budgeting.

## Budgeting

Budgeting forms part of the planning and controlling functions of management. When you are preparing a budget, you align it to the objectives set by management in their plans. An objective is a goal. In a business, every plan should have a budget. So, preparing a budget is part of the planning function of management. Controlling the activities and expenses of the budget, so that you do not spend more than is allocated in the budget, is part of the controlling function of management. The budget will show the money that is available and is also a statement of expected results.

### What is a budget?

A budget is a written document that expresses management’s goals and forecasts in financial terms for a specific future. There are various budgets in a business, like sales, production administration, materials, labour, capital expenditure, financial, cash, and master budgets. When you have money available you need to think about how you are going to use it, otherwise you may spend it and then not have any left, and you may not know what you have done with it. This process of planning how to spend money is called **budgeting**.

A budget is a plan of how you intend to spend your money. Everything you intend to spend the money on is noted or itemised.

It is the way in which you estimate how much it will cost you to run a business over a certain period of time. This period can be short (such as monthly), or longer (annually).

In your private life, a budget will help you to estimate if you will have enough money to pay for your basic expenses like rent, food, water and lights and entertainment. Without a personal budget you may not be able to have enough money throughout the month. Costs that are budgeted do not always stay the same. Sometimes you spend more on some things and less on others. For example: electricity and water can be more expensive in the winter than in the summer, if you use a heater. Groceries can be more expensive if you have family staying over with you for a period of time and you have to provide for their meals. If you have a car, and it has to go in for repairs and/or a service, your transportation costs will be higher for that month. These are called unexpected expenses. You will have to budget for that every month.

Exercise

Give examples of unexpected expenses in your personal life.

It is the same in business. If you are in the retail business you may have to buy more raw materials in winter because people need to stay warm. So they are going to buy more warm clothes to stay warm. But this also means that your income will be more because people will buy more clothes.

On the other hand, you may spend more on raw materials in summer if you are in the business of making ice-cream. However, your income as a business should increase because people are likely to buy more ice-cream.

Very important: When you draw up your budget, you must take an average of what things will cost you to cater for the ups and downs in cost. In the months when you have few expenses you must keep the money left over to cover the costs in months when the expenses are heavy.

### The need for budgets

Budgets don’t win friends but they do influence people. They can be painful to create and agonising to manage. But they do translate policy into financial terms and, whether we like it or not, that is the way in which plans must be expressed and, ultimately, performance controlled.

Budgets are needed for three reasons:

1. To show the financial implications of plans
2. To define the resources required to achieve the plans
3. To provide a means of measuring, monitoring and controlling results against the plans.

The budget is management’s most important control technique. Without a budget, the purchasing manager will not know how many materials and parts to purchase, the financial manager will not know how much capital is required, the personnel manager will not know how many employees are needed and the production manager will not know how many products have to be manufactured.

### Problems in budgeting

The main problems in budgeting are:

* An inadequate basic budgeting procedure: incorrect guidelines, unsatisfactory background data, troublesome systems, lack of technical advice and assistance to managers, unforeseen cuts in staff employment by top management
* An unskilled or cynical approach to budgeting by managers, resulting from inadequate basic procedures, lack of guidance, training or encouragement or a feeling that budgets are simply weapons to be deployed against them, rather tools for them to use
* Lack of accurate forecasts of future activity levels
* Difficulty in amending the budget in response to changing circumstances
* The fundamental weakness of basing budgets on past levels of expenditure which are simply ‘pulsed up’ rather than subjecting the whole of the budget to a critical examination
* Weaknesses in responding or controlling procedures which prevent the budget being used to monitor performance.

### Reasons for Budgeting

The main reason for budgeting is to provide a solution for long term plans as monetary plans.

The following are some of the key objectives of the budget:

* To provide detailed plans to aid the planning of annual operations
* To guide managers in an effort to co-ordinate actions which are part of the common plan
* To communicate the policies and constraints to which departments and individuals are expected to conform
* To provide a measurement tool by which managers are motivated to achieve
* To serve as a control measure against actual results to manage the exceptions
* Managers’ performances are often measured by their ability to meet budgeted objectives.

### Budget management

Budgeting concerns the future. Let’s look at reasons and ways to use actual figures and budgeted figures to manage properly and improve business.

How to use budgets

Budgets

* Budgets are the estimates we make for the future
* They help us estimate how much cash to expect and how much we will have to spend
* They help us forecast how much profit we will make.

Actual Results

* Budgets help us measure actual results
* Are the actual results the same as the budget? Are they more than the budget? Are they less than the budget?
* If they are the same, then we have done our research well and there have been no unexpected changes
* If they are not the same, then something has gone wrong.

Group Activity:

Discuss what could have gone wrong if the actual results are not the same as the budget?

### Operating budgets

For an enterprise to operate effectively it must be managed effectively. Part of the management process is planning and control. Forward planning sets specific objectives for each section of the business. Plans should be drawn up with a view to both the short and long term, and must be based on forecasts regarding demand, supply and expected technological improvements.

Budget periods are usually one year; however, these can be divided into shorter periods e.g. months, in order to co-ordinate production, sales and expense budgets.

With careful budgeting, production and financial problems can be overcome before they escalate into major disasters. Production output can be adjusted to the expected market demand by increasing or decreasing production in certain seasons or, if necessary, additional equipment can be purchased timeously to cope with increased demand.

Cash budgeting can avoid cash shortfalls by timeously making arrangements to meet unusual or seasonal cash demands.

There are certain limitations to budgets as they are merely a planned estimate and unless they are continually adjusted to prevailing circumstances they will not be effective.

Manufacturing enterprises have the added problem of budgeting for future manufacturing output.

This type of budgeting incorporates budgets, which are divided into the following sub-budgets.

* Sales budget
* Cash budget
* Production budget
* Raw materials purchases budget
* Labour budget
* Variable budgets
* Admin costs
* Capital budget
* Cash budget.

### Sales budget

The sales budget is the key budget. The other budgets can only be done once the sales budget has been done. This is because the sales budget shows the projected amount of revenue (income) that the business will generate. It stands to reason that the other budgets can only be done once we know how much money will be available, how many products or services will be sold, etc.

The preparation of the sales budget is probably the most important and complicated task since this budget constitutes the point of departure for the entire budgeting process.

It is based on the following:

1. Estimated future sales
2. Expected market conditions
3. Planned marketing strategies.

The sales budget indicates the estimated volume (units) multiplied by the estimated selling price per unit.

### Cash Budgets

A cash budget shows the expected flow of cash in a business. Cash flow is crucial to any business therefore the cash budget is a very important document. It is used to manage cash more efficiently.

The cash budget shows the opening bank balance per month, the receipts, the payments and ends with the closing balance. The closing balance indicates whether additional funds would be needed or whether there are funds available for investing.

1. We would do this exercise monthly and, if needs be, change the budgets
2. We may have to improve our own efforts and skills
3. The expense budget would have to be looked at in greater detail

### Production budget

This is where you budget for the production or manufacturing of your product. This is a very important budget due to the fact that it usually is one of the most expensive expenses in your business. Without new stock there would be no business.

To prepare a production budget, the production manager will first calculate the initial and final stock of finished products. Once s/he knows how many products were manufactured during the previous period (usually a year, but it can also be monthly, quarterly or weekly, depending on the organisation) he can work out from the sales budget how many units must be manufactured for the year and how it will be spread over the 12 months.

### Raw materials budget

Once the production budget has been done, the materials budget can be drawn up.

Raw materials are what you use to produce or manufacture your product. In a clothing retail business it will include material, thread, patterns, needles, scissors, etc. These are things that need to be purchased every month in order to manufacture your product. This is also a very important budgetary need in order to maintain your business.

The manager will use the production budget units, the quantity of the stock on hand as well as how much stock should be available at the end of the budget period.

Using these figures, he will draw up the materials budget, so that the purchasing of the materials is spread over the 12 months in such a way that there is always a minimum level of stock available.

### Labour budget

Labour is the actual work that goes into the manufacturing or selling of a product. You get people who manufacture the product who work in the factory, and you get people who sell the product who work in the business and sell the product to customers. You have to budget for these two types of labour budgets because without them there would be no product and no service.

Labour is an important part of the total cost of manufacturing the product, called the product cost. In the labour budget, the standard hours per unit product will help the manager to calculate how many man-hours will be needed for the annual production.

It is logical that the business has to know what the labour will cost to manufacture the product or to deliver the service. This is the purpose of the labour budget.

### Variable budget

Variable budgets are those budgets in a business that is changeable. It can fluctuate due to certain factors like changes in price, current trends or availability of stock. It is uncertain budgets that are flexible and you have to make sure that you include those uncertain factors in your budget when you draw it up. In other words, you always need to make sure that you budget a little more for that specific item due to the uncertainty in price and availability.

Exercise

On your own give examples of categories in a budget that are variable.

### Administrative costs

This budget details the costs involved in the collecting, processing, storage and providing of information for the whole organisation. The administration department is involved with all the other departments.

### Capital budget

Capital budget is about new office or factory buildings, installing new machinery and equipment as well as vehicles. The capital budget also affects all sections in the business and its costs will eventually form part of the general factory costs.

### Cash budget

This shows the monthly income and payments made to and by the business and will show how much money is available in the business for trading purposes as well as capital investment.

### The budget sheet

Once all the budgets for each department have been compiled, a budget sheet will be done. These budgets will show the expected budgets to be used monthly in a financial year. These are preliminary budgets for the financial year which starts 1 April and ends on 31 March. This is a very important management tool to use in order to effectively control your expenses on a monthly basis. If you achieve your expected monthly sales and comply to your budgets every month you are guaranteed to have a profit at the end of the financial year. If for instance you overspend on your telephone budget in March, you have to make sure that you under spend the next month in order to stay within your budget at the end of the financial year.

|  |
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| **BUDGET SHEET FOR FINANCIAL YEAR 1 APRIL TO 31 MARCH** |
| **EXPENSES** | **Apr** | **May** | **Jun** | **Jul** | **Aug** | **Sep** | **Oct** | **Nov** | **Dec** | **Jan** | **Feb** | **Mch** | **TOTAL** |
| **EXPECTED SALES INCOME (R)** | 150 000 | 200 000 | 200 000 | 300000 | 150000 | 120000 | 100000 | 350000 | 500000 | 100000 | 150000 | 200000 | 2520000 |
| Advertising & promotions | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 2000 | 2000 | 2000 | 1000 | 1000 | 1000 | 15000 |
| Cleaning expenses | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 1800 |
| Electricity and water | 3000 | 3500 | 3500 | 3500 | 3000 | 3000 | 3000 | 3000 | 3000 | 3000 | 3000 | 3000 | 37500 |
| Insurance | 2500 | 2500 | 2500 | 2500 | 2500 | 2500 | 2500 | 2500 | 2500 | 2500 | 2500 | 2500 | 30000 |
| Postage | 150 | 50 | 50 | 50 | 50 | 50 | 150 | 150 | 150 | 50 | 50 | 50 | 1000 |
| Printing and stationary | 200 | 200 | 200 | 200 | 200 | 200 | 300 | 400 | 500 | 200 | 200 | 200 | 19200 |
| Refreshments | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 18000 |
| Repairs | 500 | 500 | 500 | 500 | 500 | 500 | 500 | 500 | 500 | 500 | 500 | 500 | 6000 |
| Rent | 16000 | 16000 | 16000 | 16000 | 16000 | 16000 | 16000 | 16000 | 16000 | 16000 | 16000 | 16000 | 192000 |
| Salaries | 12000 | 12000 | 12000 | 12000 | 12000 | 12000 | 12000 | 21000 | 21000 | 12000 | 12000 | 12000 | 144000 |
| Telephone and fax | 3500 | 3500 | 3500 | 3500 | 3500 | 3500 | 3500 | 3500 | 3500 | 3500 | 3500 | 3500 | 42000 |
| Depreciation (wear & tear) | 500 | 500 | 500 | 500 | 500 | 500 | 500 | 500 | 500 | 500 | 500 | 500 | 6000 |
| **TOTAL BUDGET** | 39650 | 40050 | 40050 | 40050 | 39550 | 39550 | 40750 | 49850 | 49850 | 39550 | 39550 | 39550 | 498000 |
| **TOTAL EXPECTED INCOME** | 110350 | 150950 | 150950 | 259950 | 110450 | 80450 | 59250 | 300150 | 450150 | 60450 | 110450 | 160450 | 2004000 |

Please note the highlighted areas: These budgets are variable budgets due to certain factors

* In April, the postage budget is higher due to the fact that it is the first month of the new financial year and the manager must post invitations to customers to come and view the new merchandise in the store.
* In May, June and July the electricity and water budget is higher due to the fact that it is winter and electricity usage is higher.
* In October, advertising and promotions and postage budget is higher due to the busy trading and high turnover that has to be achieved in December. The manager should be pro-active and start planning for December already in October.
* In November the same applies for advertising and promotions and for postage budgets but you will note that salaries budget is much higher due to the increase in customers which leads to contract and casual staff to be appointed.
* In December the same applies as in November.

## Budgetary control

Exercise

**Group Activity:**

Before we discuss budgetary control, discuss why it is important to control budgets.

A budgetary control procedure is not easy to achieve. You have to work at it. There is no problem in designing a system with elegant forms and lots of information. The difficulty is in maintaining the scheme as a useful instrument once it has been set up. The decisions can only come from the top. Chief Executive must insist on a strict approach to building budgets and a reporting procedure which is used to make things happen the way they want them to happen. They must also ensure that everyone concerned know what is expected of them and are accountable for any failure to perform.

### The cost benefit principle

Everyone makes decisions every day. It is important in each one that the belief in the chosen course of action will be valuable.

Very important: It can be said that value is created when the benefits of a decision are greater than the costs of implementing that decision.

We will discuss cost benefit under the following sections:

* Cost benefit in your personal life
* Cost benefit in finance
* Cost benefit in business
* Cost benefit analysis tool
* Cost, benefit and tangible.

Cost benefit principle in your personal life

This cost-benefit principle applies in all spheres of life. For example, it explains why some motor car drivers deliberately exceed the maximum speed limit on the roads. For these drivers, the benefits of speeding may include arriving at their destination earlier, and spending less time driving. Or it may be to show off their high performance car. However, driving above the speed limit has potential costs. These costs include the possibility of receiving a speeding ticket, paying a higher insurance premium, or possibly being involved in an accident. The drivers that exceed the speed limits believe that the benefits which they receive exceed the costs. However, for many drivers, the expected costs of speeding are high when compared to the benefits, and this is the reason why many choose to obey the speed limit.

Cost benefit principle in finance

The cost-benefit principle also applies to finance, for instance, a financial manager only proceeds with a decision when the perceived benefits are greater than the associated costs. For example, if a motor manufacturer invests in a new factory to build a new model, there must be a belief that the future benefits, which are the revenues from sales, will exceed the cost of building and operating the new factory. This is a simple theory, but it is very powerful. Whenever the benefits of a decision exceed its costs, then it can be said that value has been created by virtue of that decision.

Cost benefit in business

In business terms, we will look at giving credit to debtors (allowing people and other businesses to buy goods now and pay later, usually within 30 days). When a firm grants credit, it takes a risk because there is some probability that the customer will not pay. In setting credit standards, the problem is to grant credit to the correct customers, even though the firm does not have complete information about them. The initial tendency is to be very strict in applying high standards. However, if the firm restricts credit to those customers whom it considers to be absolutely safe, it may lose many potential customers. Such a severe policy may result in lost sales and lower profits. At the other extreme, if the standards are set too loosely, the firm will grant credit to many customers who may not pay, and losses will be incurred.

Exercise

**Individual Activity**

Discuss why it is important to be very strict in applying high standards regarding cost benefits in business.

The problem is one of balancing the benefit of the additional sales against the cost of increasing baddebts. In principle, the firm must choose standards that maximise the difference between benefits and costs.

This principle is clear, but the difficulty is in finding the right set of credit standards. A firm will grant credit to some and refuse it to others, basing the decision on the probability that the customer will or will not pay.

It is not always necessary, or even convenient to be exceedingly strict in this matter, it is a decision for each individual firm. Some firms can afford to be more lenient than others, depending upon the product that they sell, the monetary value and the credit period that is allowed.

Cost benefit analysis tool

The cost-benefit analysis tool should be used to determine the best strategies. The cost-benefit analysis tool can be used in many different situations to assist the manager to select the best solution, options or strategies. This tool enables a manager to evaluate tangible and intangible costs against benefits in order to select the best option. This analysis ensures that the chosen option or strategy is practical, implementable, viable and feasible.

Cost, benefit and tangible

Costs refer to the risks involved if the solution or strategy is implemented or fails. Benefits refer to the positive outcomes if the solution or strategy is implemented. Tangible refers to the manifestation of actual factors or outcomes as a result of the solution or strategy. Intangible factors refer to the ‘unobvious’ or indefinable factors as a result of the solution or strategy.

## Budget and expense

We have discussed the concept of budgeting. Now we are going to discuss the relevance budgeting has to expenses. Expenses are the actual amount of money that you spend on a daily, monthly and yearly basis in your business. Expenses should never be more than your income. Your income is your actual turnover in monetary value that you make on a daily, monthly and yearly basis.

#### Expense sheet

Just like where a budget sheet tells you the available budget you have for the financial year, an expense sheet tells you your actual expenses for the financial year.

Here is an example of an actual expense sheet for a financial year starting 1 April and ending 31 March. Compare this sheet to the budget sheet under the previous heading:

**Note the following**

* Areas highlighted in red are overspent.
* Areas highlighted in blue are under spent (saving).
* Note that the turnover/sales is R206 000 less than budgeted for the financial year.
* Note that only in April and December the store made more turnover than expected.
* Note that in May, July, October, January and March they didn’t achieve their sales target.
* Note that in June, August, September, November and February they made exactly what was expected of them in turnover.
* Note that the store is over on their expenses with R4 650 on top of the fact that the store did not achieve their target for the financial year with a loss of R206 000. This puts the store in a total negative of R210 650.

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| **EXPENSE SHEET FOR FINANCIAL YEAR 1 APRIL TO 31 MARCH** |
| **EXPENSES** | **Apr** | **May** | **Jun** | **Jul** | **Aug** | **Sep** | **Oct** | **Nov** | **Dec** | **Jan** | **Feb** | **Mrt** | **TOTAL** |
| **ACTUAL SALES INCOME (R)** | 159000 | 185000 | 200 000 | 150000 | 150000 | 120000 | 110000 | 350000 | 600000 | 50000 | 150000 | 90000 | 2314000 |
| Advertising and promotions | 990 | 1000 | 1000 | 1700 | 1000 | 1000 | 2000 | 1000 | 2000 | 1000 | 1000 | 1000 |  |
| Cleaning expenses | 200 | 150 | 100 | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 150 | 150 |  |
| Electricity and water | 2850 | 4000 | 3500 | 3500 | 3000 | 3000 | 3000 | 3000 | 3000 | 3000 | 5000 | 3000 |  |
| Insurance | 2500 | 2500 | 2500 | 2500 | 2500 | 2500 | 2500 | 2500 | 2500 | 2500 | 2500 | 2500 |  |
| Postage | 150 | 150 | 50 | 250 | 50 | 50 | 350 | 150 | 150 | 50 | 50 | 50 |  |
| Printing and stationary | 350 | 200 | 150 | 200 | 200 | 200 | 300 | 400 | 500 | 200 | 200 | 200 |  |
| Refreshments | 150 | 150 | 150 | 150 | 150 | 150 | 10 | 150 | 150 | 150 | 150 | 150 |  |
| Repairs | 500 | 0 | 500 | 500 | 500 | 500 | 850 | 0 | 500 | 500 | 500 | 500 |  |
| Rent | 16000 | 16000 | 16000 | 16000 | 16000 | 16000 | 16000 | 16000 | 16000 | 16000 | 16000 | 16000 |  |
| Salaries | 12000 | 12000 | 12000 | 12000 | 12000 | 12000 | 12000 | 21000 | 21000 | 12000 | 12000 | 12000 |  |
| Telephone and fax | 3500 | 4800 | 3500 | 5200 | 3500 | 3500 | 3500 | 3500 | 3500 | 3500 | 3500 | 3500 |  |
| Depreciation (wear and tear) | 500 | 500 | 500 | 500 | 500 | 500 | 500 | 500 | 500 | 500 | 500 | 500 |  |
| **TOTAL** **EXPENSES** | 39490 | 41450 | 39950 | 42650 | 39550 | 39550 | 41160 | 48350 | 49850 | 39550 | 41550 | 39550 | 502650 |
| **OVER/UNDER****SPENT?** | 160 | 1400 | 100 | 2600 | 0 | 0 | 410 | 1500 | 0 | 0 | 2000 | 0 | 4650 |

#### The benefits of under spending

If a business gives you a certain budget it is in the store’s best interest to stay within the budget or to save where they can in all categories of the budget. This will result in a profit for the store at the end of the financial year and possibly a bigger increment for the manager and staff as well. You must also keep in mind that whatever you actually spend in one financial year will be the budget for the next financial year. For this reason it is sometimes necessary to make sure you use whatever budget is available otherwise you will have a smaller budget for the next financial year. You can also only use your available budget if your store achieves its budgeted turnover (target). If you do not achieve your turnover you should concentrate even more on saving wherever you can.

Exercise

**Individual Activity:**

Give examples of ways where you can save in your personal budget.

#### The disadvantages of overspending

If you think about your own purse and the amount of money that is in there, imagine the following: Say you go to the supermarket to buy groceries and you have only R500 in your purse. You cannot buy for more than R500 because that is the only money available to you. In a business, it works exactly the same with a budget. A budget is the actual amount of money that you have available to spend in the different categories. If you spend more than you have available you will be in debt and you will have to make it up the following month. What if something unexpected happens in your store and you are not able to save on that specific category? Let’s look at an example: If you have R150 to spend on cleaning in January and you spend R200, you have overspent with R50, so in February you only have R100 to spend on cleaning. (Budget: R150 – R50 that you’ve overspent in January). What if your store has water damage and you have to buy more mops and cleaning agents in February? You won’t be able to save and you will be behind for the financial year. It is very difficult to cut back on budgets if you have overspent during the previous months.

### Measure actual results against the budget

Sometimes in business it can happen that actual results do not agree with the budget. Let’s look at some reasons why actual results do not agree with budgets:

#### Actual results more than budget

* We sold more than we expected. This could be a problem because if we sell more we also spent more. Sometimes a small increase in sales can cause large increases in expenditure.
* Perhaps we should put our selling prices up.
* We overcharged customers.
* If we sell more than one product, perhaps our estimates of sales for each product were wrong. This is called the product mix.
* Adding mistakes in our records.

#### Actual results less than budget

* We did not sell as much as we expected. Our research or sales ability is at fault.
* We gave too much discount or undercharged customers.
* Our product mix was not the same as budget.
* We left figures out of, or made adding mistakes in our records.

#### Purchases budget

* Sales are more / less than budget.
* Price increases.
* Over / undercharges or mistakes on suppliers’ invoices.
* Mistakes in our records.

#### Expense budget

* Sales are more / less than budget.
* Price increases.
* Not controlling expenses.
* Over / undercharges or mistakes on suppliers’ invoices.
* Mistakes in our records.

## The budget technique

Like everything else in a business, how to budget is sometimes a complicated matter. If you use the correct technique it can help you to ensure that your budgets and expenses are in line and that you achieve the expected sales results.

### Preparing budgets

Most of the problems concerning the preparation of budgets mentioned in the previous section can be reduced, if not eliminated, if the following steps are taken:

* Prepare budget guidelines which set out policies on where you want to go and, broadly, how you want to get there. These could be expressed as targets for sales production or activity levels, and as an outline for the major marketing and production plans. In addition, the assumptions to be used in budgeting should be given. These could include rates of inflation and increases in costs and prices.
* Ensure that those responsible for preparing budgets are given advice and encouragement by management accounts. These experts should be there to help, not to prod or threaten.
* Do not accept any significant increases, decreases or even deviations from last year’s budget without an explanation.
* Probe to ensure that budgets submitted to you are realistic and do not include a ‘fudge factor’
* Do not slash budgets arbitrarily. Give reasons. If you don’t, you will get ‘fudge factors’ or a couldn’t-care-less attitude.
* Update or ‘flex’ budgets regularly, especially when activity levels and costs are subject to large variations.

### Techniques in the budgeting process

Let’s look at some techniques that can be used in order to simplify the budgeting process. We will look at:

* Zero based budgeting
* Forecasting
* Based on historic data
* The long range plan
* Defining constraints on the budget
* Preparing the sales budget
* Preparation of detailed budgets
* Consolidation of budgets
* Budget review.

Exercise

**Group Activity:**

Before we discuss each of the above points, get together in your groups and shortly give the meaning of each of the above. You may use a dictionary.

### Zero-based budgeting

Zero based budgets are often used, with a starting point of “what are the absolute essentials” to achieve pre-set objectives. The traditional approach to budgeting tends to perpetuate the commitments of previous years. For instance, past levels of expenditure are used as a base from which to project increases or decreases. Only part of the budget is analysed, and managers concentrate on justifying increases, rather than challenging the need for any function or activity in its present form.

Zero-based or priority-based budgeting requires budget managers to systematically re-evaluate all their activities and programmes in order to establish their relative priorities and decide whether they should be eliminated or funded at a reduced, similar or increased level. Appropriate funding levels will be determined by the priorities established by top management and the overall availability of funds.

Each activity is broken down into defined decision units, and each unit is analysed to establish:

* Its objectives
* The activities carried out
* The present costs of these activities
* The benefits resulting from each activity
* The standards and other performance measures that exist
* Alternative ways of achieving objectives
* Priorities among the objectives
* The advantages and disadvantages of incurring different levels of expenditure.

This is a fairly exhaustive list, and the amount of detail you want to pursue will depend on the importance you attach to a rigorous examination of expenditure. Zero-base budgeting is no panacea (cure-all) and it has often failed because companies have introduced over-elaborate procedures which have sunk almost without trace in a sea of paperwork. But the approach is right: cost control is about challenging and justifying proposed expenditures as well as monitoring what has actually been spent.

The most elaborate control system in the world is useless if its foundation is unsound. The emphasis should be on their value in getting priorities right and ensuring that costs and benefits are thoroughly reviewed to the advantage of all concerned.

### Forecasting

Forecasting is when you plan beforehand what might happen, usually in an economic environment. If you look at the recession that we are experiencing, this is a perfect example of something that was forecasted by economists. Such factors should be considered when you plan and work out your budget.

#### Based on historic data

Historic data is very effective when planning your budget. If you are in a clothing retail business, you need to look at the turnover trends of the previous year. If you know that your busiest trading months was for example November and December, you need to plan in advance for your budgets for this financial year’s months of November and December. If you know that Mothers Day is a high turnover promotion, you need to plan beforehand for that. Planning based on historic data means that you must consider the various categories (for example cleaning, postage, salaries etc.) and work out which categories will spend more money on the various promotions. On Mothers Day you will spend more money on postage because you will have to send out invitations to your customers to come and visit your store.

### The long range plan

Management must communicate the long term plan to those involved in the budgeting process. These include growth rate, inflation rate, salary and wage increases, the exchange rate expected for imports or exports, and other main indicators on policy and constraints.

#### Defining constraints of the budget

Examples are sales growth or the availability of resources such as capital or expert knowledge.

#### Preparing the sales budget

This includes new products, discontinuing current products and growth and pricing of the product range. This part of the budget is normally the most important part of the budget. Methods may vary, but will normally include the opinions of executives and sales personnel.

### Preparation of detailed budgets

A budget can be prepared by adopting a “bottom up” approach whereby the lowest level of management prepares detailed budgets for their department or cost centre. Past actual figures may be used, but there is no guarantee that what happened in the past will repeat itself in the future.

A well constructed budget based on expected standards may be used for setting costing standards. This is particularly relevant in reporting variances from budgets and standard costs if using the same performance standard.

#### Consolidation of budget

Managers will normally present their detailed budgets to their superiors.

Top management will finally approve the budget in this consolidated form, provided that it meets their expectations and includes the assumptions arrived at by the long term strategic plan.

#### Budget review

The final budget will be expressed in terms of an income statement, balance sheet and cash flow statement. This will be compared to past years’ actual results.

#### The sales budget

Revenue or income is all the money coming into the business: sales, income from services rendered, rent income, interests from investments, etc.

The first budget or forecast that must be done is the sales budget (forecast). I must work out (estimate) what sales I will expect in the future (preferably for twelve months).

I must remember to take into account things like school and public holidays or anything else that will affect my sales

How do I work out sales?

The normal practice is to start with the previous year’s sales and then add a percentage. If you feel you can increase sales by 10%, you would increase the sales for each month by 10%.

#### Expenses budget

Before you can work out true costs, you must know what your expenses and loan repayments are going to be. Expenses are what the money is spent on, e.g. insurance, tax, loans, salaries, etc.

Profit

Profit = Income from sales less all costs or expenses. The portion of money which is left over in the business after all costs have been covered is profit.

Let’s look at an example:

Mr. Trader has budgeted R20 000 sales for the month of June.

His expenses for the same month are R9 000. He will have to pay R8 000 for the goods he wants to sell.

He wants R3 000 profit for the month.

Sales R20 000.00

Less Purchases R 8 000.00

Difference R12 000.00

The difference is made up as follows:

Expenses R 9 000.00

Expected Profit R 3 000.00

Total R12 000.00

* The difference is called the **mark-up** and is made up of **budgeted expenses** plus **expected profit.**
* This amount is also called the **gross profit.**

Service Industries

People providing a service are not making any product or buying goods to sell.

They will calculate what their expenses are and add the profit they want. If they repair things, they will have to add spares to the total.

Let’s look at two examples:

**Example 1**

Mr. Washer is a launderette operator. He estimates that he will have 300 customers a month. His expenses are R3 000 per month. He wants R1 500 per month profit.

 Budgeted expenses R3 000

 Expected profit R1 500

 Budgeted sales R4 500

**Example 2**

Mr Rod is a radio repairman. He estimates his expense at R2 500 per month, spares at R500 per month. He wants R2 000 per month profit.

 Budgeted spares R 500

 Budgeted expenses R2 500

 Expected profit R2 000

 Budgeted Sales R5 000

Flexible budgets

If it is possible, with a reasonable degree of accuracy, to relate changes in income and costs to levels of activity, the use of flexible budgets is worthwhile. Budgets are ‘flexed’ by recalculating income and costs which vary with activity levels by reference to actual activity level, thus giving an ‘expected’ level of income and costs.

The difference between the original and expected levels is termed an **‘activity variance’** and the difference between expected levels and actual levels is a **‘controllable variance’**. It is on the latter figure that you must concentrate if you want a realistic picture of how costs are performing.

Budgets should be set up in such a way that the information can be used to regularly review results. It should be amended for forecasting purposes as the year progresses.

#### Steps involved in successful budgeting

Initially you may wish to draw up an estimate of the budget you will need. Drawing up an estimate is a logical exercise that is based on the available information about:

* the department’s outcome: objectives
* the department’s activities
* information about the costs of identical or similar activities.

You can use the budgets for previous year’s budgets but beware of just taking previous figures and adding a small percentage for inflation as you may discover that you have underspent.

Obtain as much information as you can

Also look at trends which may give you an indication of possible escalations of costs e.g. if you have to do a lot of travelling, be sensitive to possible petrol price increases.

If you are involved in a building project and may have to use equipment or parts which have to be sourced from overseas, be sensitive to the Rand / Dollar exchange rate.

Discuss with management

Once you have an initial estimate, this will be discussed with management. When initial approval has been received then a more detailed budget will need to be put in place.

Provide for contingencies

Exercise

**Individual Activity:**

What do contingencies mean?

Provision must be made for costs such as:

* insurance
* tax charges.

Provision must also be made for contingencies, as things are bound to go wrong. A useful rule of thumb is 5% - 15% of the projected expenditure.

Remember:

The department budget is the financial foundation of the department. It tells you what is to be spent and when it is to be spent. It is essential that the budget is a true reflection of what has to be expected. You will have to monitor the budget closely, and provide accurate information to your manager and the team about the cash flow situation.

Components defined

* **Labour:** The wages paid to all staff directly working in the department. This would include both permanent and outsourced contract staff.
* **Overhead:** The cost of payroll taxes and fringe benefits for everyone directly working in the department. This is usually calculated as a percentage of direct labour cost.
* **Materials:** The cost of items purchased for use in the department. It could include raw materials such as lumber, cement, steel, nails, screws, rivets, bolts, and paint (if your organisation builds houses). It could also be items such as paper, manuals etc. These could be described as **consumables**.
* **Supplies:** The cost of tools, equipment, furniture, computers, office supplies, etc., needed for the project. If something has a useful life beyond the project, a proportion of the costs should be allocated to the project. These can also be described as **establishment costs**.
* **Equipment:** The cost of purchasing or renting equipment such as scaffolding, compressors, cranes, bulldozers, trucks, etc., for use on the project.
* **General and Administrative:** The cost of management and support services such as purchasing, accounting, secretarial, etc., for time dedicated to the department. Usually calculated as a percentage of department cost.
* **Profit:** In a for-profit project, the reward to the organisation for successfully completing the project is usually calculated as a percentage of project cost.

#### Potential budgeting problems

* The impact of inflation on long-term projects.
* The impact of currency exchange rates on international projects
* Failure to obtain firm price commitments from suppliers and sub-contractors.
* Poorly prepared Work Breakdown Structures that lead to incomplete budgets
* Estimates based on different methods of costing, i.e. hours versus Rand.
* Inaccurate contingency provision.

### Drawing up a budget

A budget is a living and workingdocument, as well as a continuous learning experience. To make it work, you must keep a record of real income and real expenses. This will help you budget more realistically in future.

A budget should always be one year ahead (so you budget each month for next month and for a period up to the next year).

A planned budget is completed at the beginning of the year; this will vary from month to month, due to expenses not always being the same.

Let’s look at the example of a personal budget:

* **Fixed expenses** are your bond, school fees, insurances, amounts that remain the same every month.
* Groceries, transport, water and electricity, cell phone, entertainment and sundries are all expenses that you have every month, but they will differ from month to month. These are called **variable expenses**.

Once you have completed a personal budget the same principles and methods can be applied to companies, provinces and nations.

**Basic terminology**

|  |  |
| --- | --- |
| Gross salary | * Salary before tax, PAYE, UIF, medical aid on your pay slip
 |
| Net salary | * Salary that gets paid into your bank account
 |
| Sundries | * Various expenses, not consistent every month e.g. clothes, medicine, birthday presents, repairs etc.
 |

Example of a personal budget

Sipho earns a net (after deductions) salary of R5 475.00 per month. He has the following monthly expenses in October:

|  |  |
| --- | --- |
| Bond on his house  | R1 450.00 |
| Transport  | R1 350.00 |
| Groceries  | R 800.00 |
| School fees  | R 240.00 |
| Cell phone  | R 196.00 |
| Clothing account | R 250.00 |
| Entertainment  | R 300.00 |
| Other/Sundries  | R 150.00 |
| Savings | R 100.00 |

Sipho’s October budget:

Income R5 475.00

Bond on his house R1 450.00

Water and electricity R 3 000.00

Transport R1 350.00

Groceries R 800.00

School fees R 240.00

Cell phone R 196.00

Clothing account R 250.00

Entertainment R 300.00

Sundries R 150.00

Total R 5136.00

Less Expenses R5 136.00

Net Cash Flow R 339.00

Beginning Cash Balance R 315.00 (money remaining from September)

Ending balance R 654.00

From Sipho’s budget we can make the following deductions:

He is living within his means i.e. he is not spending more than he is earning. This is what we need to maintain in order to ensure financial discipline.

Sipho could open a savings or investment account of R150.00 per month, or take out a life insurance policy or funeral cover insurance for R150.00 per month and still remain within his budget.

Annual income/expenses

To calculate annual income/expenses, we take the monthly income/expenses and multiply it by 12, because there are 12 months in the year.

Annual income = R5 475.00 x 12

 = R65 700.00

Annual expenses = R5 036.00 x 12

 = R60 432.00

Savings

If Sipho were to save R150.00 per month, after 1 year (12 months) he would have R1 800.00 extra to spend on a holiday, or buy something for his home like a TV, radio etc.

Cash balance

In September Sipho had a cash balance of R315.00, this was the money remaining in his account after all his expenses had been paid, and it is money that he has not spent.

This amount may vary from month to month, due to sundry expenses, such as birthdays, repairs to their home, clothes that need to be bought, medical accounts etc. So Sipho’s actual budget varies from his planned budget.

How to use budgets

* Budgets are the estimates we make for the future
* They help us estimate how much cash to expect and how much we will have to spend
* They help us forecast how much profit we will make.

Exercise

**Group Activity:**

Discuss more reasons why using budgets are important.

Actual results

* Budgets help us measure actual results
* Are the actual results the same as the budget? Are they more than the budget? Are they less than the budget?
* If they are the same, then we have done our research well and there have been no unexpected changes
* If they are not the same, then something has gone wrong.

#### Document a cost budget

A proposed project budget should clearly describe cost headings and provisional estimations. The headings should include a costing of:

* Human resources or skills,
* Administrative processes,
* Materials and supplies, and
* Provisional extra costs.

A description of each heading follows.

#### Human resources or skills costs

The costs of skills required to implement the project. This should involve a description of responsibilities and salaries for:

* Full-time personnel,
* Part-time personnel (include percentage of work time covered by salary), and / or
* Consultants (include number of days and daily fee).

#### Administrative costs

Administrative costs include:

* Venues, accommodation needed for residence during the project cycle
* Communications and postage (telephones, faxes, courier services, publications, advertising, etc.) It is normal practice to list these under one common heading rather than separately unless a specific item is expected to take a significant portion of these costs
* Travel required for project purposes (expected vehicle costs, air travel, etc.).

Materials and supply costs

Costs of materials and other project-related supplies.

Provisional extra costs

Other expected sources of expense, for example:

* Meetings and entertainment,
* Temporary rentals (transport, equipment, etc.),
* Food (lunch, snacks, tea or coffee, etc.), or even
* Interpreting.

#### Follow standard accounting procedures

Financial accounting information must be assembled and reported objectively. Principles of prudence and consistency must be followed, for example if you budget for depreciation, choose the method of calculating depreciation and stick to this method.

Make sure that estimates are based on valid and actual figures so that there is not a big difference between budgeted costs and actual costs.

Also make sure that your budget stays within the amount allocated.

Formative assessment SO1 AC 1 – 2

# SECTION 2: ELEMENTS OF A BUDGET

#### Specific outcome 2

Determine the elements of a budget in an area of responsibility.

#### Assessment criteria

* The elements of the budget are identified for the resources required to meet the objectives.
* Internal and external constraints on a budget are identified in terms of an own organisational context.

## The Elements Of A Budget

If we look at the elements of a budget we look at simple and easy ways to make budgeting possible for everyone. We will take a budget and break it down into categories and explain each one individually.

A budget exists of the following:

* Financial year
* Months in a financial year
* Categories in a budget
* Totals in a budget (expected sales and expenses)
* Overspending or under spending.

### Financial year

A financial year is normally from 1 April until 31 March the next year. It is exactly 12 months (a year) but does not start from January to December like a calendar year. The reason for this is that most businesses use the same financial year as the Government in order to fall into line with their budgeting. In order to have a profit at the end of a financial year you need to comply with the budgets in each category. You also need to generate the turnover (money) that was budgeted for each month. Refer to the budgeting sheet in the previous section for an example of a budget.

#### Months in a financial year

As we have discussed under “financial year”, the months in a financial year start from 1 April to 31 March of the following year. The months do not necessarily start from, for example, 1 January to 31 January but usually from the first Sunday of the month till the last Saturday of the month. A trading week is from Sunday to Saturday.

Look at this example of a financial year trading calendar for the month of January 2009:

|  |
| --- |
| **JANUARY 2009** |
| **SUNDAY** | **MONDAY** | **TUESDAY** | **WEDNESDAY** | **THURSDAY** | **FRIDAY** | **SATURDAY** |
| 2 | 3 | 4 | 5 | 6 | 7 | 8 |
| 9 | 10 | 11 | 12 | 13 | 14 | 15 |
| 16 | 17 | 18 | 19 | 20 | 21 | 22 |
| 23 | 24 | 25 | 26 | 27 | 28 | 29 |

* Take note that the first day of the trading month January starts on the 2nd and the last trading day is the 29th.
* Note that the trading week starts on a Sunday and ends on a Saturday.
* The budgets of the different categories for January should be spent during the period of the 2nd and the 29th of January.

### Categories in a budget

Categories in a budget are all the possible expenses that a business might have during a financial year. In retail you will have the following expense categories:

* Cleaning
* Postage
* Printing and stationary
* Water and electricity
* Salaries
* Depreciation (wear and tear)
* Telephone and fax
* Advertising and promotions
* Insurance
* Refreshments
* Repairs
* Rent.

Under these categories you get controllable and non-controllable expenses.

Exercise

**Individual Activity:**

Before we discuss controllable- and non-controllable expenses, explain in your own words what you understand under each.

### Expenses

#### Controllable expenses

Controllable expenses are those expenses that you have a direct impact upon. If you look at the cleaning category, it is all the things you buy in order to have a clean working environment like tile cleaner, wood polish, dishwashing liquid etc. You can control this expense by buying only what is really necessary. If your budget is R150 for cleaning purposes, you need to stay within that budget and not spend more than that. Like we have discussed previously, you should try to spend whatever your budget is, in order to have enough budget for the following financial year due to the fact that you budget will be your actual expenses in the next year. It is very important to remember that if you do not achieve the required turnover you should cut back on all your budgeted categories.

#### Non-controllable expenses

Non-controllable expenses are those expenses that you cannot change. If you look at the category “insurance”, it is a fixed amount that needs to be paid each month. It is very important to know exactly what your insurance premiums are in order to budget correctly for that. Also ask your insurance company if the premiums may change during the financial year in order for you to budget for that.

#### Totals in a budget

Totals in a budget are all the totals of expected sales, budgets in the different categories, expected expenses and the totals that were over- or under spent at the end of a financial year.

The totals in a financial year budget are divided into 2 sub-categories:

1. Expected sales
2. Expenses.

**Expected sales**

The totals for expected sales in a financial year are all the totals accumulated from March to April. It is all the sales that a business is expected to generate during the financial year. Because a business has a budget for expected sales, the business is given direction on how much turnover (money) is expected from them in order to generate a profit at the end of the financial year.

**Expenses**

Expenses are the total budget for all the expense categories in a financial year. It is important to keep in mind that your expenses can never be more than your income, in business and your personal life. That is why a budget is so important and why it is so vital to strictly stick to your budget.

#### Overspending and under spending

In a budget it is very important to remember that you should never overspend but rather under spend.

Let’s look at the importance of both:

**Overspending on a budget**

A budget is there for a reason. The reason is to stick to the budget and ensure that you don’t spend more than the available budget. Remember again that you can never spend more than you have. You will be in debt at the end of the month and once in debt it is difficult to get out of it and balance your budget again.

**Under spending on a budget**

If you under spend on a budget it is for your own benefit. It saves you money and ensures that you have a great profit at the end of the financial year. Some businesses even give their employees profit sharing if they control their budgets well during the financial year. Whatever you save during the financial year gets added to your profit at the end of the financial year which gives your business a greater percentage growth.

## Internal and external constraints on a budget

In every business there are internal (within the business) and external (not within the business) constraints on a budget. Constraints mean to restrict freedom of action, in other words it directs you away from your original budget. Constraints are a negative element when it comes to budgeting but it is wise to make provision for that. Let’s look at some examples of internal- and external constraints on a budget.

Exercise

**Individual Activity**

In order for you to understand internal- and external constraints on a budget, give examples of both before we discuss it in detail.

### Internal constraints on a budget

We will discuss the following internal constraints. Remember internal constraints are within the company.

* Owner’s equity
* Discounts
* Depreciation
* Managers that overspend
* Budgets too low
* Dividends
* Current liabilities.

**Owner’s equity**

Owner’s equity is the claim against the assets of the business entity (shareholder’s equity). Equity is the issued share capital of a company (also equity capital); the shareholders' interest in a company. This is a very important factor that has to be considered when working out a budget.

**Discounts**

A discount means money off the "full" price of goods. The "full" price may be the recommended retail price that has been published by the manufacturer or the price shown on the seller's price list, known as the List Price.

Traders often sell their goods at different prices to different customers. There may be several reasons for giving a special price on a particular deal.

Apart from the example of the customer buying goods for his own business that you have just seen, discounts may be given because the customer is buying a large quantity of the goods concerned, or because the trader and the customer have a long term association such as when the customer makes regular purchases. In a true cash discount, the actual selling price will not be known until payment is made.

The effect of discount on gross profit

Over and above the fact that the offer of a discount does not always have the desired effect on the total sales, it often happens that a discount lowers the gross profit (in terms of monetary value).

Assume that an entrepreneur decides to offer his clients a 10% discount in the hope of having his sales increase by 20%. The effect of this discount on the gross profit of the entrepreneur is as follows:

|  |  |  |
| --- | --- | --- |
|  | **Without discount****R** | **With discount****R** |
| Cost price per article  | 5.00 | 5.00 |
| Plus mark-up | 2.50 | 2.50 |
| Normal selling price per article | 7.50 |  |
| Less discount (10%) |  | 0.75 |
| Real selling price | 7.50 | 6.75 |
| Number of units sold | 100 units | 120 units |
| **Total sales** | **750.00** | **810.00** |

|  |  |  |
| --- | --- | --- |
| **BUT** | **Without discount****R** | **With discount****R** |
| Total sales | 750.00 | 810.00 |
| Less cost price of sales | 100.00 (100 units) | 120.00 (120 units) |
| **Gross profit** | **250.00** | **210.00** |

Although the dealer sells 20% more, his gross profit actually declined by R40, 00 or 16%.

For the above dealer to still make a gross profit of R250,00 after allowing the 10% discount, his sales (in units) have to increase by more or less 43%. The computation is as follows:

Desired gross profit = R250,00

Gross profit per unit after discount:

=Selling price less Cost Price

= R6,75 – R5,00

= R1,75

Sales in units (needed for gross profit or R250,00)

= 250 divided by R1,75

= 143 units

Sales therefore have to increase from 100 units to 143 units in order to realise the same gross profit as before the discount.

The following table gives an indication of the extent to which turnover has to increase to keep the gross profit constant when cash discounts are offered.

|  |  |  |
| --- | --- | --- |
| **Mark-up on cost price** | **Discount** | **Percentage increase in turnover needed to maintain level of gross profit** |
| 50% | 5%10%15%20% | 17,6%42,9%81,8%150,0% |
| 33,33% | 2,5%5%10% | 11,1%25,0%66,7% |
| 25% | 2,5%5%10% | 14,3%33,3%100,0% |

**Depreciation**

The essential difference between expenses and assets is that expense items are bought, used, and replenished at frequent intervals whereas the length of time between buying and replacing Fixed Assets are measured in years. This does not alter the fact that while a Fixed Asset exists, its value is constantly being reduced by wear and tear and/or deterioration.

Depreciation is a reduction in accounting earnings which is intended to reflect the reduction in value of an income-producing asset. Depreciation, itself, is not cash flow, but it affects cash through taxes. As a result of this, every capital budgeting analysis must consider the depreciation tax shield, which is the reduction in taxes due to the depreciation charge. This depreciation tax shield is a cash flow, because it reduces the cash outlay for taxes by the amount of the depreciation tax shield.

To understand how the depreciation expense creates a tax shield we will consider a manufacturer:

The firm has an operating cash flow of R50 000. The example below examines the after tax cash flow of the manufacturer with and without a depreciation expense of R15 000 for a compressor.

No depreciation.

|  |  |
| --- | --- |
| Total sales  | R300 000 |
| Less Cost of goods sold | -R250 000 |
| Gross income | R50 000 |
| Less Depreciation expense | 0 |
| Taxable income | R50 000 |
| Less Taxes (30%) | R15 000 |
| Net income: | R35 000 |
| After-tax cash flow | R35 000 |

#### With depreciation

|  |  |
| --- | --- |
| R300 000 ‑R250 000 = | R50 000 |
| Less depreciation | R15 000 |
| Taxable income | R35 000 |
| Less Taxes (30%) | R10 500 |
| Net income | R39500 |
| After tax cash flow | R39 500 |

If the firm can deduct the R15 000 depreciation expense, it pays R4 500 less tax. This R4 500 savings on the tax bill is the depreciation tax shield

The depreciation tax shield depends on the amount of the depreciation charge.

Calculate depreciation

The simplest method to calculate depreciation is to use two basic factors: time and use, where use is more important. When a vehicle travels high kilometers per year, the number of years that the vehicle can be used becomes less. This means that the number of years over which the vehicle will be depreciated becomes smaller.

There is an approximate amount of kilometers that a vehicle can be used before it reaches the end of its economic life.

If we look at a small pick-up truck, the number of kilometers could be 100 000. If the pick-up truck travels 50 000km per year, the depreciation write-off will be done over 2 years, if the pick-up truck travels 20 000km per year, the write-off will be done over 5 years.

As an example: the cost of a vehicle to be written off is R350 000. This amount is made up of the purchase price, less tyres, less the resale value. This particular vehicle has an economic life of 125 000km on frequent long-distance trips and a life of 80 000km on local work in congested urban traffic.

Depreciation cost per kilometer is:

R350 000

÷125 000

= R2, 80 for the vehicle that travels long distance

R350 000

÷80 000

= R4, 38 for the locally operated vehicle.

Depreciation can be calculated in two ways:

* Straight line method
* Reducing balance method.

**Straight line method**: where the amount to be depreciated is divided equally by the number of years over which the vehicle will be depreciated:

Vehicle cost price R350 000

Tyres: six tyres at R1500 each R 9 000

Anticipated life: 5 years

Anticipated vehicle resale value after 5 years R200 000

Straight line method:

Original cost less tyre costs less anticipated resale value

Anticipated life

= annual depreciation

R350 00 - R9 000 - R200 000

5 years

= R141 000

 5

= R28 200 per year

In this calculation, the vehicle will have what is called a book value or R200 000. If the vehicle is sold for less than this amount, it will result in a loss on sale of asset.

**Reducing balance method**: where a high level is shown in the early life of the vehicle when maintenance costs are low. The level then reduces steadily in later years when maintenance costs increase:

Vehicle cost price R350 000

Tyres: six tyres at R1 500 each R 9 000

Anticipated working life: 5 years

Depreciation per year 20%

Amount to be depreciated: R350 000 - R9 000 R341 000

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Capital** | **Annual depreciation** | **Balance carried forward** |
| **Year 1** | 341 000 X 20% | 68 200 | 272 800 |
| **Year 2** | 272 800 X 20% | 54 650 | 218 420 |
| **Year 3** | 218 400 X 20% | 43 648 | 174 592 |
| **Year 4** | 174 592 X 20% | 34 918 | 139 674 |
| **Year 5** | 139 674 X 20% | 27 935 | 111 739 |

According to this method, the vehicle will have a book value of R111 739 in the company’s books. If the vehicle is sold for less than this amount, it will result in a loss on sale of asset. If the vehicle is sold for more than the book value, say R120 079, there will be a profit from sale of asset of R8 340.

Both methods are acceptable accounting practice. When you start making this calculation, use the method preferred by the organisation and the accounting officers.

In accounting terms the value of fixed assets is calculated as follows:

Fixed assets = plant and equipment at cost - the accumulated depreciation

#### Managers that overspend

It is the responsibility of the business manager to ensure that he/she does not overspend on budgets. The reason why they receive their budgets when the financial year starts is for them to have a direction where to go with their business for the whole of the financial year. If they overspend during one month they need to under spend the following month. If they overspend every month there would be no profit at the end of the financial year because overspending on a budget is a loss for any business. It is not something that you can make up after the end of the financial year. For that reason a manager should be aware of his/her budgets and expenses and how much they are over or under.

Exercise

**Group Activity:**

Discuss how staff can cause budgets to be over spent.

#### Budgets that are too low

If a business allows too little budget in any category it makes it difficult and sometimes impossible for managers to manage their budgets effectively. Head Office where the budgets for the financial year are usually drawn up should make 100% sure that they are aware of all the elements a budget consists of. They should consider facts like unforeseen circumstances and also the actual expenses of the previous year. If they notice that the actuals of a given category are much lower than the budget which was allocated to that category, they should use their own discression and allocate a budget which is in line with expenses.

#### Dividends

A dividend is an amount payable to shareholders from the distributable reserve of a company.

Dividends are a budgetable category that needs to be included internally when a budget is being drawn up. It is a controllable expense in the sense that the business is able to determine how much each shareholder will get. It can also be a non-controllable expense if the company performs over or under their expected budget.

#### Current liabilities

Current liabilities are expenses which are expected to be settled within the next 12 months. It is an internal budget due to the fact that the business is aware of their debts and should include it in their financial year budget. The business should ensure that their current liabilities are not too high in order to show a profit at the end of the financial year.

### External constraints on a budget

We will discuss the following external constraints. Remember external constraints are outside of the company.

* Unexpected expenses
* Interest
* VAT
* Revenue
* Extraordinary items.

#### Unexpected expenses

Unexpected expenses can make or break a business. If it is unexpected in the sense that it can generate more turnover for the business, it is to the advantage of the business. If it is unexpected and it causes the business to lose profit, it is to the disadvantage to the business. Examples of unexpected expenses are water damage, global recession and natural disasters.

#### Interest

Interest is the amount of money that is charged on bank loans. It works in percentages and can change at any time. You need to budget for changeable interests as it depends on the banks of the country.

#### Interest

Interest is the cost of money - it is money which is paid for the privilege to use the money. Interest is a very important aspect in every day life and business. Whether you buy a house, car or use a credit card, or invest for retirement or invest in business, the fluctuation in interest rates will influence you. It is vital to be able to understand and manage interest for your benefit.

**Interest rates** are based on the supply and demand of money. When the supply is good, the money gets cheaper (interest rates are lower); when the supply is poor, the money gets more expensive (interest rates are higher).

Interest rates can change at any time. If too many people want to borrow money, or if the Reserve Bank decides that there is too much money in circulation, then interest rates go up.

If too few people are borrowing money, interest rates usually go down. It works in the same way as the supply and demand for goods. When the interest rate goes up, the money borrowed becomes more expensive, repayment amount increases proportionally and it may take longer to repay the loan.

The calculation of interest may be ‘simple’ or ‘compound’. **Simple interest** is the application of a percentage rate to the principal sum for the period in question

Money required: R 10 000

Interest rate: 22, 5%

Pay back period: One Year

What is the interest in, rand per month?

R 10 000 X 22.5 divide by 12

 1 100

R187.50

What is the total interest payable over the one year period?

R 187, 50 x 12

= R 2 250, 00

What is the total monthly payment?

R 833, 33 + R 187, 50 = R 1 020, 83

What is the interest per month if the interest rate increases by another 1, 5%?

R 10 000 x 24

 1 100

= R2 400

What is the total interest payable over the one year period if the increase came into effect at the beginning of the seventh month?

R 10 000 x 22,5 divide by 12 X 6

 1 100

= R1125, 00

R 10 000 X 24 divide by 12 X 6

=R1 200, 00

R 1 125+ R 1 200

= R 2 325

#### VAT

The abbreviation VAT stands for “Value Added Tax”. VAT is 14% of the selling price at the moment. If an item costs R100 the selling price will be R114. This is a tax-deductable amount and can be claimed back from the Revenue office at the end of the tax year.

Exercise

**Individual Activity:**

Discuss where VAT goes and what happens to the money that we pay on VAT.

Value Added Tax – an introduction

Value Added Tax is precisely what it says. It is a tax on the value that is added to goods as they pass from one trader to another

The idea of Value Added Tax, of course, is related to the idea that businesses exist to make a profit. They do this by buying goods at one price and selling them for a higher price. In the case of a shop, it is simply a matter of buying and selling. In the case of a factory, processes are also carried out on the goods which further add to their value.

You should also notice that Value Added Tax applies to services as well as goods. This is because somebody who is selling a service has put a value on that service in deciding what to charge.

For instance, let's say that you take some clothes to the dry cleaners. They are not selling you goods because you already own the clothes. They are selling you a service which has a value so that the price you are charged will include Value Added Tax.

The rules are such that all businesses must **register** for **VAT** unless they are extremely small or only deal with goods where **VAT** does not apply.

The question of what is meant by a small business is measured by their turnover - how much money passes through the business in a year - and not by number of employees. The maximum turnover figure for exemption from VAT Registration is adjusted by the Government every year. In 2008 the amount was increased to one million rand per year.

Why VAT is important

1. Most business **must** register for VAT.
2. A VAT registered business **must** charge VAT and so collect it for the Government.
3. A Business that is not VAT registered **cannot** charge VAT.

With regard to these points, you may wish to notice that a VAT registered trader must show his **VAT registration number** on his invoices. If you are ever charged VAT on an invoice that does not show the registration number, you should query it. It may be that someone is trying to get money from you under false pretences!

You will probably have guessed that most businesses do not register for VAT unless they have to, as being registered will involve them in extra, unpaid work for the Government.

However, there is one advantage to being registered. This is that a VAT registered business is able to offset the VAT it pays against the VAT it collects. In the following pages you will see that the system operates in such a way that the last person in the line of sales and purchases pays all the tax. The others along the line get back all the VAT they have paid at the end of the day.

Therefore, it is quite possible that a very small business that pays a lot of VAT on its purchases may find it worthwhile to register despite it not being compulsory.

In accountancy and bookkeeping, VAT is classified as being either **input** tax or **output** tax.

Input tax is the amount of VAT we pay to a supplier when we buy an item from him.

Output tax is the amount of VAT we collect from a customer when we sell an item.

The amount we have to pay to the Government is the difference between the Input and Output taxes. You will appreciate that, because the purpose of a business is to make a profit, Output tax will normally be greater than Input tax.

Output tax minus input tax = balance payable to government

In practical terms, it is equivalent to the business getting a refund of any VAT it pays. If Input tax is greater than Output tax the business will receive the difference from the Government. This can make it very worthwhile for a small trader to register!

The Government department which administers VAT is SA Revenue Services

Businesses normally deal with their local office. You can find out the address of your local office by looking in the telephone directory.

Every two months, the VAT registered business has to complete a **VAT return form** giving the totals of Input and Output taxes for the period. The cheque for the difference is sent off with the form.

Imagine a person (A) who chops down a tree and sells it to a furniture manufacturer (B) who makes a table from it and sells it to a shop (C) which then sells it to a customer (D).

What prices are involved in VAT

Since the tree was growing there anyway, the value that A puts on it is the cost of felling it plus some profit ‑ let's say R100.

B buys the tree for R100, puts in R130 worth of work into it and adds, say, R20 for profit. As a result, B sells the table to C for R250.

C has running expenses for his shop and also needs to make a profit. So he decides to sell it to D for R330.

These prices are what A, B, and C wants for them! If they are all registered for VAT, they will all have to add the tax on to their invoices.

Let's assume that all three are registered for VAT. Currently, the VAT rate is 14%.

As a result, each of these traders will add 14% VAT to their selling prices. This is their Output tax.

The 14% VAT that B pays to A is B's Input tax. Similarly, the 14% VAT that C pays to B is C's Input tax.

A sells to B at R100 + 14% VAT R14 = R114

B sells to C at R250 + 14% VAT R35 Total = R285. The VAT that B pays to SARS is: R35 – R 14 = R21.

C sells to D at R330 + 14% VAT R46.20 = R 376.20. The VAT that C pays to SARS is: R46.20 – R35.00 = R 11.20

The total that is paid to SARS is therefore:

A R14.00

B R21.00

C R11.20

Total R46.20

As you can see, it is the final customer, D, who ends up by paying all the VAT. You can also see that each trader pays a portion of the total VAT to SARS. Each portion matches the value that has been added to the item at each stage.

In South Africa we have three kinds of VAT, depending on the products or services involved:

Products and services that attract VAT at 14%, such as furniture, clothes, etc.

Products and services that are VAT zero rated, such as meat. In this instance, the company can claim input tax, but does not pay output tax at all. There are also no VAT charges on the products. These companies usually receive a refund from SARS.

Products and services that are exempted from VAT: no input tax is claimed and no output tax is paid. VAT is not charged on products and services.

Tax is the portion of your income that needs to be paid to the Government at the end of the tax year. The portion that each business and individual pays usually are used to upgrade the country’s infrastructures. Infrastructures are things like roads, buildings and to pay of Government debts. Businesses and individuals usually receive a percentage of their revenue back after all taxable deductions was made like entertainment, the purchasing of business related items and transportable deductions.

Revenue is the income received by a business. It includes income from sales, interest, dividends and royalties. Income from sales is the income received from the number of items that are sold, or services rendered.

Once sales have been worked out for a period of time, say one week or one month, the sales can be compared with the budget, and/or estimated sales.

Sales can be increased by:

1. Selling more to the customers.
2. Finding more customers.
3. Changing prices

In the case of non profit organisations, revenue is also referred to as gross receipts. Revenue includes: donations from individuals and corporations, support from government agencies, income from activities related to the organization's mission and income from fundraising activities, membership dues, and financial investments such as stock shares in companies.

Governments also generate income in the form of income tax levied on companies and individuals, customs and excise duties, other taxes, dividends, interest, sales of goods and services and other taxes.

#### Extraordinary items

Extraordinary items are items of incomes or expenses which result from events or transactions outside the ordinary activities of the business and which are material in amount.

Exercise

**Group Activity:**

Give examples of extraordinary items.

Formative assessment SO 2 AC 1 – 2

# SECTION 3: MONITOR AND CONTROL ACTUAL EXPENSES

#### Specific outcome 3

Monitor and control actual expenses against a budget

#### Assessment criteria

* Actual expenses are monitored according to standard operating procedures.
* Variances are identified and corrective measures are proposed and/or taken according to standard operating procedures.

## Monitor and control expenses against a budget

It is of vital importance to monitor your expenses against your budget on an ongoing basis right through the financial year. We have discussed how to draw up a budget using all the elements. Now we will discuss how your actual expenses can be monitored and controlled in order to ensure that you do not overspend on your budget categories.

We will discuss the following:

* Income
* Expense (cost)

### Income

There are two basic types of income:

1. Income from your trading or service operation e.g. sales, commissions, etc. This is also called revenue.
2. Income from other sources e.g. interest received, dividends, profit on sale of fixed assets, etc.

### Expenses (Costs)

It is an outflow of cash or other valuable assets from a person or company to another person or company. This outflow of cash is generally one side of a trade for products or services that have equal or better current or future value to the buyer than to the seller.

There are two basic types of expenses:

1. Fixed overhead expenses
2. Variable expenses.

Exercise

**Group Activity:**

Before we discuss fixed- and variable expenses, do your own research of both in order for you to be prepared when we discuss both in detail.

#### Fixed overhead expenses

These expenses refer to the ongoing expenses of operating a business. Overhead expenses must be paid whether you are trading or not. They are not directly related to sales or manufacture but are necessary to the continued functioning of the business, even though they do not directly generate profits. Overhead expenses include for example:

* accounting
* advertising
* depreciation
* insurance
* interest fees
* legal fees
* quality control
* storage and handling
* rent
* taxes
* telephone
* travel and
* indirect administration labour costs, including supervision, reception, etc.

#### Variable expenses

These are directly related to the manufacture or sales process, such as:

* materials used
* labour
* commission
* equipment
* transport
* resources.

Manufacturing firms manufacture products. They use raw materials that are regarded as a variable expense. When they produce less of the product, they also use fewer raw materials, which mean that spending will fall. Of course, if they produce more products, they will use more raw materials and spending will rise.

Note that the changes in expenses happen with little or no need for managerial intervention.

### Monitor expenses

It does not help to have the best plan in the world if you do not monitor and control your project. This is an on-going activity, which requires a great deal of attention.

We do not work in a perfect world but in one that is dynamic. As such, things will go wrong, people will let you down, goods will not arrive on time, and key workers will become ill. A good project manager must have the flexibility and resilience to cope with these problems.

Monitoring allows us to identify when things are not going according to plan and gives us the opportunity to evolve an action plan to resolve the problem.

What does monitoring involve?

In order to successfully monitor expenses against a budget you need to do the following:

* Measuring
* Recording
* Analyzing
* Data and information used
* Remedial activities
* Obtain actual cost figures.

Exercise

**Individual Activity:**

On your own, what does measuring mean regarding budgeting?

#### Measuring

All budgets need to be measured against achievable outcomes. Another word for measuring in this regard is to compare. A business has to keep all previous records of budgets (previous financial year for example) in mind when calculating budgets.

#### Recording

Budgets need to be recorded in order to have proof of the previous financial year. To record means exactly what it says. Businesses should have all their systems updated on a monthly basis in order to have records of budgets and expenses for that specific month. It is wise to have back-up of whatever you record on computer systems due to the fact that systems can crash which will cause you to lose important data.

#### Analyzing

To analyze means to examine something critically in order to bring out essential elements or structures. This is a very important step in budgeting and when you compare the expenses to the budget. You need to be critical but also fair when analyzing. If a store over spends in a certain category you cannot immediately penalize them but you need to find out why they are over spending. The simplest way to find out why is by contacting the manager. Another great management style is when you instruct all managers to note over- and under spending at the end of each month of the financial year due to the fact that it is human to forget. Let managers draw up a report of over- and under spending each month and forward it to head office. By doing this it is easy to refer back when you look for reasons of over- and under spending. (See “budget control chart” under the heading “identify deviations” for more information).

The data used or information gained must be*:*

* relevant
* credible
* timely
* understandable
* connected to the project plan and budget.

A useful strategy is to set project milestones, which allows us to see if we are making progress according to our agreed schedule.

Project control is an on-going activity.

It should be agreed with your team what control measures will be put in place and how often they will be reviewed.

However, even with good control measures, problems will occur. These are discovered through our monitoring activities.

 When we discover that a discrepancy has occurred between what has been planned and what is being delivered, then we are able to take remedial action and take firmer control of activities.

The remedial activity should be

Exercise

**Group Activity:**

What does remedial mean and give examples in your group.

* appropriate
* quick
* cost effective
* reflect the size and nature of the gap.

Obtain actual cost figures

On a regular basis, obtain the actual costs in order to compare them with the budgeted costs. You will find records of actual costs from finance and administration departments, e.g.

* Invoices indicating the actual prices of items that were bought
* Telephone and water and light accounts showing actual expenditure
* Records of the actual payroll for amounts spent on salaries and wages
* Details of insurance premiums, rental of premises and equipment.

Update the amount spent on cost items continually to determine whether spending is still within budget or whether corrective action should be taken.

## Identify variances and take corrective action

Whenever there are variances in a budget it might sometimes be necessary to take corrective action as soon as possible and not wait until the end of the financial year when it is too late. Here are some ways and solutions to prevent this from happening:

### Identify opportunities for corrective action

In the case where actual expenses become greater than planned expenses, project management will have to consider whether to:

* Refine the objectives set out (for example building fewer houses than originally planned),
* Include other sources of income (such as increasing the price of houses built for sale afterwards), or
* Obtain more funding (loans and investments).

All deviations from the budget – overspending and under spending) must be investigated to find the cause. The deviation must also be reported to project management according to the procedures of the project. This can be done during a weekly project progress meeting or, if the matter is urgent, can be reported to project management under cover of a memo or a report.

Be sure to describe the deviation, the cause of the deviation and add your recommendations for further action.

If necessary, and on approval of management, amend the budget and send the amended budget to all stakeholders.

### Maintain financial records

Projects have to be audited, so all documentation must follow the procedures laid down for the project. Also, records of all documents must be kept:

* Memos
* Reports
* Minutes of meetings
* Budgets
* Budget control charts
* Amended budgets
* Source documents for costs such as payrolls, invoices, lease agreements, etc.

Exercise

**Individual Activity:**

Explain why it is important to maintain financial records.

These documents must be filed in a safe and fireproof place, such as a filing cabinet in a safe, or on computers, depending on the procedure laid down by the company. If documents are saved on computers, regular backups must be made and kept in a safe and fireproof place.

### Identify deviations

Deviation means an action of changing direction or an amount by which a single measurement differs from the mean. In other words deviation is when figures in a budget don’t add up to the correct totals. Let’s look at ways to identify deviation:

#### Budget control chart

A budget control chart is used to detail the following:

* What has to be spent on which cluster or items or activities
* When the money has to be spent.

The projected cash flow will be calculated when the budget is compiled and it is very important that this is monitored carefully on a regular basis.

If we are unable to manage our cash flow it will have serious implications for achieving the other targets we have set ourselves.

The Budget Control Chart compares the progress of actual project costs with estimated project costs. This chart is used to keep relevant costs in line with what can be afforded and warns project management of possible price or cost escalations which may require a readjustment in the overall budget or a change in task priorities.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Category** | **Budgeted Cost** | **Anticipated Cost** | **Actual Cost** | **Notes** |
|  |  |  |  |  |
|  |  |  |  |  |
|  |  |  |  |  |

If your monitoring reflects a variance in the actual as opposed to the actual and predicted amounts spent, this has to be investigated. If your investigation indicates that future costs may exceed the budget provision, then the matter needs to be investigated and decisions made.

Figures tell a story

Accountants will tell you that figures tell a story. When managing projects you need to learn how to read the story.

Fortunately if you use a computer Project Management program, the computer will assist you to calculate and interpret figures quickly.

Critical ratio

However it is useful to understand how to calculate the Critical Ratio. Let us look at an example:

You have allowed 32 hours for a trench to be dug and a pipe-line to be laid. The total budget for labour is R1 000.

After 32 hours you discover that only 75% of the work has been done and that R1 200 has been spent on labour costs.

You realise that you have a problem and you wish to see how critical the situation is. You therefore apply the formula to establish the critical ratio.

(Actual progress / Scheduled progress) x (Budgeted cost / Actual cost)

(75 / 100) x (R1 000 x R1 200) = (0.75) x (0.83) – 0.62

When the ratio falls below 1.0 this tells you that you have a below-par performance and it needs to be investigated. Similarly, if the ratio is above 1.0 then you need to investigate the above-par performance.

The further the ratio is away from 1.0 the more urgent is the need to investigate.

Formative assessment SO3 AC 1 – 2

# FORMATIVE ASSESSMENT

Formative assessment SO1 AC 1 – 2

This is a group activity

* Refer to your section or department.
* Draw up a list of expenses you think apply to your section or department
* Develop a zero-based budget on what you think the monthly expenses would be
* Now develop a budget for next year based on forecasting. Use the figures of your zero-based budget as historical data. Increase expenses with between 5% and 10%, and 45% for the electricity.

Formative assessment SO 2 AC 1 – 2

This is an individual activity

Refer to the previous assessment

Determine the elements of the budget for your department or section, based on the previous assessment as well as what you know about your department or section

Identify internal and external constraints on the budget as they exist in your organisation

Discuss your findings in groups

Formative assessment SO3 AC 1 – 2

This is a group assessment

* Discuss monitoring and control of budgets as they apply to your organisation
* Explain how actual expenses are monitored. Is this system effective? What would you do differently?
* What reports are required from your department regarding variances to the budget and what corrective action is usually taken?