Unit B3

Manage the Use of Financial Resources

■ *Scope*

This unit asserts that the management of financial resources has a strategic dimension in addition to the day-to-day operational perspective. This requires managers to appreciate the following:

- **A suitable amount of funds is available to the organisation**
- **As they are required**
- **At the minimum costs**

The unit has two elements:

B3.1 Make Recommendations for Expenditure
B3.2 Control Expenditure against Budgets

The Chartered Institute of Management Accountants define a budget as,

"A plan in monetary terms, prepared and approved prior to a defined period of time, usually showing planned income to be generated and/or expenditure to be incurred during that period and the capital to be employed to attain a given objective".

Point to Ponder

This definition highlights the fact that budgeting is simply not all about a pot of money but is in essence a planning tool, embracing all resources and provides managers with a control facility by giving regular feedback on performance. The financial planning – budgeting – process has three main elements: **objectives, planning** and **control**. First, the objectives of the organisation are set and translated into plans in tune with the relevant policies and procedures endorsed by the executive team. These plans are then expressed in monetary terms to form the budget and monitored against performance. Any deviations from budgeted performance will be highlighted through regular feedback and corrective action taken. It must be remembered that budgeting is not a mechanistic process.

The planning which the budget represents and the control processes related to it involve every member of the organisation; such involvement alone can provide the commitment and the singular motivating factor though out the organisation. Budgets are not supposed be cast in tablets of stone and handed down from above but are to be the final product of a lot of flexible negotiations between all levels of management, ensuring the involvement of all in setting challenging but realistic targets for all parts of the organisation. The budget setting should include:

- **Every manager's knowledge, initiative and experience taken into consideration**
- **Every manager being given a part in the planning process**
- **Every manager being made aware of how his or her specific function fits into the overall operational picture of the organisation**
- **Every manager and department being made aware of the importance of inter-departmental co-operation**
- **Lower level managers are made aware of the policies and goals of the business so that they are familiar with the problems that can arise if budgeted and actual performance are not in alignment**

A budget that all members have an involvement in firming up is likely to be accepted by all as they are the ones whose job it is to make it work.

The budget is a **communication channel** from management, all the way down. Usefulness of a budget for control purposes is reliant on clear, sound policies and procedures highlighting authority and accountability of each manager. Costs, revenues, assets and liabilities should be traceable to the managers who are initially making the decisions about them. The key roles of finance and budgeting are:

Planning:

- **Producing forecasts and budgets**
- **Ensuring that the organisation has enough cash to survive**
- **Allocating money in line with the objectives and policies of the organisation**
- **Setting targets for the organisation and each department within it**

Controlling:

- **Monitoring income by checking that each department achieves its targets**
- **Monitoring expenditure by ensuring that no department overspends**
- **Monitoring the overall position by making sure that profit targets are met and the organisation does not run out of cash**

Reporting:

- **Classification of transactions into different categories**
- **Summarising for different users**
- **Reporting on performance internally and externally**

Decision-making:

- **Helping the organisation to achieve its financial targets such as increasing wealth for owners**
- **Helping the organisation to make investment decisions**
- **Helping the organisation to identify its sources of funding**

■ *Some Financial Terms*

Financial accounting - attempts to meet the needs of stakeholders and includes summary reports without a great deal of detail. This is subject to regulations and is of a standard formal format. Tends to be annual or six monthly, looks at the past year or six months, may be audited by an auditor and indicates the financial position of the organisation.

Management accounting - seeks to meet the needs of the managers, therefore is very detailed and focused on specific needs. It does not require a standard format and is produced as frequently as needed with forecasts.

Financial statements –

- **cash flow statement –** to measure the cash in and cash out of the organisation over a given period of time
- **profit & loss account –** profit & loss account – to measure the profit generated over a specific period of time; a breakdown of all incoming and outgoing finance for a particular period, finishing with overall profit or loss
- **balance sheet –** a snapshot of the financial position of the organisation, balancing assets against capital and liabilities

Turnover – total value of sales over a given period, sometimes called income or revenue.

Cost – the amount of actual or notional expenditure incurred on or attributable to a specific thing or activity. (Fixed, variable, direct or indirect.)

- **Direct costs are directly related to the cost of producing the goods or services (cost of sales). For example, goods purchased for resale, labour costs, raw materials, packaging. Direct costs vary with sales.**
- **Indirect costs or overheads are costs which are not directly related to sales as these are incurred even when the organisation is producing no output; for example, administrative salaries, advertising, stationery, rent and rates, insurance, bank charges. These do not vary with sales.**

Creditors – suppliers of goods and services whose invoices are still outstanding for payment.

Debtors – customers who owe the organisation money.

Assets – items which the organisation owns.

Liabilities – things which the organisation owes.

Accrued expenses – any amount which the organisation owes for expenses already consumed but for which a bill has yet not been received or paid.

Pre-paid expenses – goods or services which have been paid for in advance.

Bad debt – a debt which is unlikely to be paid by the customer.

Book-keeping – the recording of monetary transactions in sufficient detail to enable its accuracy to be checked so that the relevant summarised information can be extracted.

Investigate

1. Your department has a budget of £2,800.00 for annual team building events. You hired a mini bus to take 15 members of staff to an outward bound centre. The cost of the coach was £100.00 but it easily accommodated the team. Although the facility was subsidised by government grants, it still cost £65.00 each plus £15.20 per head for meals and refreshments. 13 people ordered wine with their meal and put £5.00 each in to a 'kitty'; they consumed 7 bottles of house wine at £8.00 a bottle. On the day you spent £52.50 on petrol. Produce a <u>Cash flow statement, Profit and loss account and a Balance sheet</u> for the day spent on team building.

Budgeting is a management function not simply an accounting function. Ideally all levels of management should have a good understanding of the nature and objectives of the organisation's budget and participate in its preparation. All members should be convinced that the budgeting process is a means of creating and **maintaining** a spirit of teamwork and co-operation. Although the main responsibility for the creation and maintenance of the budget rests with the Finance Director or their equivalent, all managers are responsible for preparing and submitting for consideration and incorporation into the main budget plan, their own departmental budgets in accordance with the policies set by the organisation; failure to do this will result in ineffective analysis of information and low performance. Before the budget is incorporated, it will be reviewed by senior management to make sure that it is realistic and reflects the standards of performance expected.

In preparing budgets for ongoing activities, several approaches are used; one such approach is called **incremental budgeting** – prepared on the basis which is incremental to the costs and revenues from existing activities. Past outcomes in respect of both revenues and costs are used as a base for preparing the budget for the forthcoming period. Adjustments are then made to reflect expected price changes, inflation or changes in volume or the nature of activities to be undertaken.

Zero based budgeting is where managers are required to justify their budget requests in detail, with the onus of proof firmly placed on them to justify the expenditure their proposals will incur. The main feature of this method is that the managers prepare the budgets for the cost of operating their activities at a minimum level of service, then go on to identify separately the costs and benefits of additions to the activity for which they are responsible. It is suggested that this method generally improves the performance of middle and lower level management as they will be required to continually evaluate their own efficiency and effectiveness in providing value for money and achieving objectives.

Activity based budgeting builds upon the philosophy of zero based budgeting, calculated on the understanding that activities generate costs; as such an analysis of activities as the driver of costs should lead to a more realistic assessment of essential resources.

Fixed budgeting is designed to remain unchanged regardless of the amount of output or any other activity. This type of budgeting is suitable for business where there are no changes in the levels of activity which do not affect its revenues or costs.

Flexible budgeting or variable budgets are those which are meant to change according to the fluctuations in activity, output or sales. In this type of budgeting, the cost behaviour pattern of each item is acknowledged by readjusting the budget allowance in the light of actual level of activities.

Investigate

2. ***Reflecting on your organisation, how familiar are you with the budget setting process? If you are not, find out how it is done. What do you consider are the strengths and weaknesses of this process? Analyse.***

   Do you currently have any budgetary responsibilities? If you do not, explore what impact this has in your function as a manager; if you do, explain the benefits and any recommendations.

■ *The Budget Setting Process*

(Broadbent & Cullen, Managing Financial Resources, 1993)

Identify key objectives for the year

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Determine key limiting factors

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Prepare initial sales or income forecast

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Prepare initial departmental budget

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Negotiation

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Coordination to remove inconsistencies

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Consolidation into master budget

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Approval of final budget

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Ongoing review and monitoring

Cost-benefit analysis is a monetary assessment of the total costs and revenues or benefits of a project, paying particular attention to the social costs and benefits which do not normally feature in conventional costing exercises. In business, the usual method of testing the 'soundness' of any proposed activities is investment appraisal where the value of the resources to be employed in them (the costs) are compared with the value of the goods or services to be produced (the benefits). Then, all running costs are subtracted from the annual value of receipts leaving a residual; this is expressed as the annual rate of return on the capital employed. If this anticipated return compares well with the prospective rates obtainable from the alternative uses to which the capital might be invested, then the project is deemed sound.

In contrast, many public sector services such as roads and schools are provided without direct prices being charged for them. Whilst the cost can be calculated, it is very difficult to place a value in monetary terms on the benefits emerging from the satisfaction of needs and wants of people in the community. There may also be social costs involved which are difficult to measure. This is the feature that differentiates cost-benefit analysis from investment appraisal in business.

This is broader than cash or profit based analysis. Relevant where economic or market factors provide insufficient information for decision-making.

The difficulties of this process include:

- **Estimating the value of social costs**
- **Allowing for changes in levels of costs and benefits over time**
- **Imprecise procedure – assumptions need to be specific**
- **Ideally should show a range of results using different criteria**

An example is the extension of an Expressway:

- **Costs –** capital expenditure. Running costs. Disruption during construction. Additional traffic around neighbouring villages
- **Benefits –** time saved on traffic jams. Comfort/convenience. Attracting more visitors/ businesses due to increased road facilities. Costs saved on regular road repairs. Reduced accidents. Reduced pollution resulting from slow moving traffic. Reduced noise

The comparison of costs with the expected benefits of a project is an important form of investment appraisal. The opportunity cost must be taken into consideration – it is the measure of something that is lost when a choice has to be made between alternative courses of action. It is the cost in terms of lost income or profit of the foregone alternative investment; in other words, what could be earned if the money available was invested in other projects.

Investigate

3. Suppose you have a number of agency staff working in your department because of work overload. You now consider that setting up a full time post will be a lot more effective. You need to convince your managers that this is a good idea through your budget planning process. In preparation for this, do an investment appraisal.

The purpose of this unit is not to make you a finance expert, but it is important to equip yourself with the knowledge to enable you to take part in managing an organisation's financial resources. Therefore, instead of 'number crunching', the idea behind this unit is to make you appreciate the general framework of financial planning, management and capital investment. **Investment decisions** will normally be with regards to the planning and implementation of activities such as:

- **The acquisition of fixed assets – land, buildings, machinery for instance**
- **Investment in special projects – research, marketing for instance**
- **Expansion of existing activities**
- **Diversification into new areas of the market**
- **Investment in training and development of personnel**

Capital budgeting is the process of selecting and planning capital investments based on an analysis of cashflows associated with the investments and appraisals of the benefits they are likely to bring about. It is based on the assumption that in return for paying out a given amount of cash today, a larger amount will be paid back over a period of time. Capital budgeting and investment appraisal procedures often require choices to be made from a number of options.

Where competing alternatives exist, managers have to make decisions by analysing the various features of each of them; your appreciation of cash flow, the determination of revenues, depreciation, and the predicted rate of return on investment for instance, will stand you in good stead in creating a portfolio of differing types of investments to smooth out the pattern of annual cash returns to the organisation.

Once set, the budget is constantly under **budgetary control**. The five principles of control are:

- **Plan what needs to be achieved**
- **Measure regularly what has been achieved**
- **Compare actual achievements with the plan**
- **Take action to correct deviations from the plan**
- **Feed back results to amend the plan as required**

■ *Guidance for Gathering Evidence for this Unit*

All elements call for a personal narrative from you explaining your involvement in any cost/expenditure improvement plans – these could be very simple things; the intention is to indicate your understanding of the principles of financial control, not that you handle millions of pounds! You should also clearly indicate where you have provided supplementary work evidence.

Possible Sources of Supporting Evidence

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Possible Source of Evidence	*Used*	*Location in Workplace/Portfolio*
Your budget plans/proposals submitted for screening by senior managers; evidence of advice or suggestions you might have given to team members; colleagues or managers regarding changes, amendments, additions to expenditure		
Evidence of any ideas you might have presented for increasing financial control, cost efficiency, income generation or cost reduction		
Minutes of meetings where you have asked others to generate ideas regarding your budget		
Any option appraisals you might have done prior to recommending any expenditure		
Any documents showing your spend against budgets, explaining any variations and showing corrective action		
Meeting minutes relating to discussions on budgets		
Candidate's Signature:		
Assessor's Signature:		

Evidence Location Reference

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Evidence Reference Identifier	*Location in Workplace/Portfolio*	*Date Assessor Viewed/Comments*
Candidate's Signature:		
Assessor's Signature:		