Chapter MP3 script 52

Budgets, Forecasts and Business Plans

In this recording we summarise the content of chapter 52 Budgets, Forecasts and Business Plans. Studying this chapter should help you evaluate the purpose of budgeting in organizations; discuss the process for developing budgets; describe the key contents of a typical business plan; apply investment appraisal techniques such as NPV and IRR; .

Introducing the chapter, the authors start with 1. In this chapter we explore financial planning and control mechanisms and techniques for allocating financial resources. Today practically every type of organisation practises some form of budgetary control. Budgets are used to implement strategy (see chapter 17) by managing tactical issues and the allocation of resources to attain goals. The process of budgeting was briefly referred to in Chapter 28 (Control). We noted in that chapter that a budgetary control system is laid on the foundations of strategy (goals), forecasts, sales and production budgets, capital expenditure and cash budgets, and departmental/unit budgets. All these subsidiary budgets are integrated to form a Master Budget for the organisation, which becomes in effect a projected Profit and Loss statement and Balance Sheet.
2. Budgets are statements of desired performance expressed in financial terms. They represent the tactical or operational end of business activities, and can be applied to different organisational contexts in which individual managers are given responsibility for a particular unit of operation, which typically may be a revenue centre, cost centre or profit centre. The essential features of these three responsibility centres are as follows:
A revenue centre (income centre) is a unit such as a sales section within an organization where income is accumulated and identified with a specific project or organisational entity; the manager is held accountable for the revenue generated by the subunit
A cost centre is usually a unit which serves other parts of the organisation (e.g. HR, IT, Accounts etc) and which is allocated a budget based on the costs of operating the service at an agreed level; Cost centres account for related expenses - they add to the cost of an organization, but add only indirectly to its profit
A profit centre is a part of an organisation that adds directly to its profit/ run as a business with profit objectives; it is a subset of the business for which senior managers want to track income and expenses..

The key concepts discussed within this chapter are:
budget - statements of desired performance expressed in financial terms; typically a financial plan to manage the spending and saving of money; business plan - a document that summarizes how an entrepreneur will organize a firm to exploit an opportunity, along with the economic implications of exploiting that opportunity; Capital budgeting - the process of analyzing and selecting various proposals for capital expenditures; Net Present Value (NPV) - An investment appraisal technique that determines the amount of money an investment is worth, taking into account its cost, earnings, and the time value of money; .

Other terms discussed include:
cost benefit analysis ; Cost Centres; Internal Rate of Return (IRR); Mutually exclusive; Payback period; profit centre; Profit-And-Loss Centres; revenue centre; .

Summarising and concluding, the author(s) make the following comments - 30. In this chapter we explored financial planning and control mechanisms and techniques for allocating financial resources. Budgets are statements of desired performance, expressed in financial terms. They indicate how much should be spent, by which departments, when, and for what purpose. All budgets should be prepared against the backcloth of wider organisational plans. Budgets are used to anticipate future costs and revenues, prioritise and control spending, and ensure that expenses do not exceed available funds and revenues. A generic Budget development process was presented. Next we noted that businesses need to know they have enough cash available to fund their immediate operating expenses such as wages/ salaries, rent, telephone charges etc. The most usual way of keeping track of the cash position is to prepare a cash flow forecast. This is essentially a budget which sets out the estimated receipts and payments of the business on a month-by-month basis over a period of one financial year.

31. Investment decisions are important for all organisations; the purpose of investment is to increase value and ultimately cause cash to flow into the organisation. Once business objectives/ goals have been set in the strategy-making process, investment opportunities and needs can be identified. Data is then assembled about costs and benefits associated with the investment opportunities (CBA Cost Benefit Analysis). It is rarely possible to fund all investment opportunities, or in some cases some opportunities may seek to tackle the same problem. It is therefore necessary to choose the projects within which to invest. Numerous quantitative approaches for evaluating investments are available such as, net present value (NPV), internal rate of return (IRR), payback period and pay-off tables. The main goal of such techniques and investment appraisal is to assess the profit (increase in wealth) for a given period.

32. Budgets and forecasts are examples of business plans. However, the expression ‘Business Plan’ has particular meaning for small and medium-sized enterprises and here the main interested parties are (a) owners and (b) lenders and investors. The business plan is a written document that summarizes how an entrepreneur will organise a firm to exploit an opportunity, along with the economic implications of exploiting that opportunity..

We have now reached the end of the chapter   'Budgets, Forecasts and Business Plans'.

There are a number of references for this chapter where further reading opportunities are identified for you.

Additionally, there are questions or activities to help develop and test your understanding of this chapter