

Fundamentals of Budgeting

(Training Manual for Students)

Written by: Mr. Bashir Hazim

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Budgeting – Why & How?

Definition

A budget is an estimation of revenue and expenses over a specified future period of time; it is compiled and re-evaluated on a periodic basis. Budgets can be made for a person, a family, a group of people, a business, a government, a country, a multinational organization or just about anything else that makes and spends money. At companies and organizations, a budget is an internal tool used by management and is often not required for reporting by external parties. It outlines an organization's financial and operational goals.

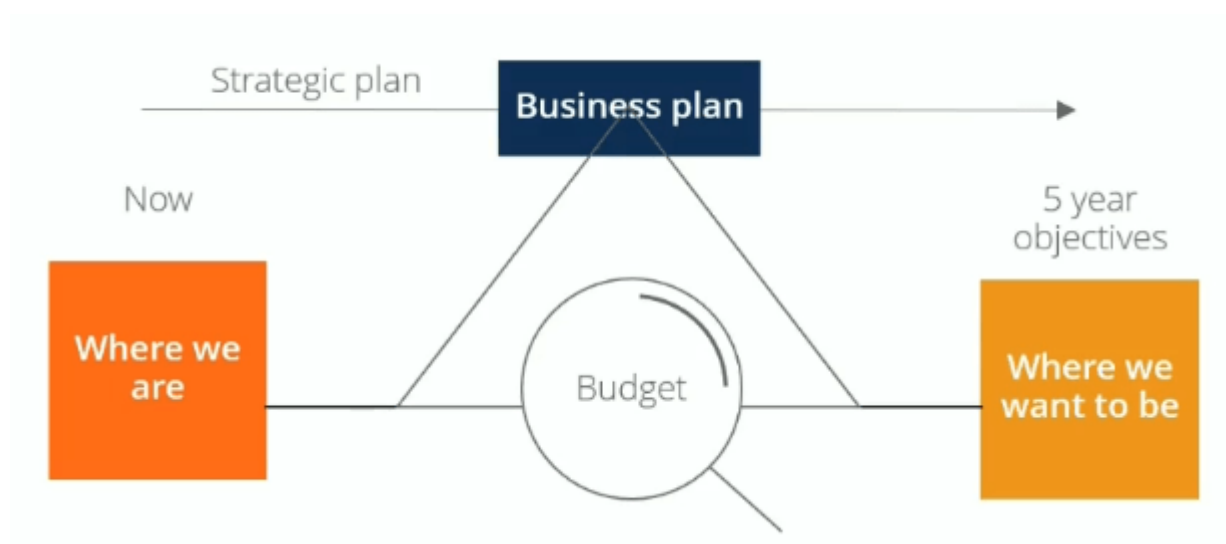
Budgeting is more than just a job we have to get done to satisfy the financial department. Planning and budgeting can help us lead our team to success. Sometimes, when we write a plan, we catch errors. It's a lot better to catch errors in a plan than to have problems later on in the office or on the shop floor because you didn't catch the errors. In fact, it's been shown that good planning will typically reduce the costs of a project by about a factor of 10.

A Corporate budgeting refers to the process by which a business estimates its finances for a future period and plans its operations accordingly. In developing a corporate budget, a business usually starts with a project plan, then determines the amount of time, goals and costs of the project.

Function

To achieve its goals, a business must express its strategy in a measurable way. The business must determine whether a project is financially feasible, then link the corporate goals with the available resources. Corporate budgeting allows higher management develop a strategy that makes sense to those in the lower levels of the organization.

It is a tactical implementation of a business plan. To achieve the goals in a business' strategic plan, we need some type of budget that finances the business plan, sets measures and indicators of performance, and then make changes along the way to ensure that we arrive at the company's goals.



Dimensions

There are four dimensions to consider when translating high-level strategy, such as mission, vision, and goals, into budgets.

1. **Objectives** are basically your goals, e.g., increasing the amount each customer spends at your retail store.
2. Then, you develop one or more **strategies** to achieve your goals. The company can increase customer spending through expanding product offerings, sourcing new suppliers, promotion, etc.
3. You need to track and evaluate the effectiveness of the strategies, using relevant **measures**. For example, you can measure the average weekly spending per customer and average price changes as inputs.
4. Finally, you should set **targets** that you would like to reach by the end of a certain period. The targets should be quantifiable and time-based, such as an increase in the volume of sales or increase in the number of products sold.

Objectives	Strategies	Measures	Targets
What are you trying to achieve?	How are you going to achieve it?	What are the input and output measures?	Quantifiable and time-based
<ul style="list-style-type: none"> • Increase spend per customer 	<ul style="list-style-type: none"> • Expand product offering • Source new suppliers • Promotion and marketing • Pricing 	<ul style="list-style-type: none"> • Average weekly spend/customer • Spend by product type • Average price changes 	<ul style="list-style-type: none"> • \$ increase • Volume increase • % staff trained in new products

Why do we make a budget?

There are several good reasons to create a budget and to make it a good one. The reasons are tied to the people who will read and use the budget. Each reader will look at the budget in a different way and do something different with it. If you know your readers, you can make a budget that will impress everyone— and, more important, show how your group is contributing to the organization and therefore approve the funds you need to proceed. If you know how the budget will be used, you will know how to write it in an easy-to-use way. More important, it will help you succeed and show that you are a good manager and that your team is doing a good job.

Budgeting is a critical process for any businesses in several ways.

1. Aids in the planning of actual operations.

The budgeting process gets managers to consider how conditions may change and what steps they need to take, while also allowing managers to understand how to address problems when they arise.

2. Co-ordinates the activities of the organization

Budgeting encourages managers to build relationships with the other parts of the operation and understand how the various departments and teams interact with each other and how they all support the overall organization.

3. Communicating plans to various managers

Communicating plans to managers is an important social aspect of the budgeting process, which ensures that everyone gets a clear understanding of

how they support the organization. It encourages communication of individual goals, plans, and initiatives, which all roll up together to support the growth of the business. It also ensures appropriate individuals are made accountable for implementing the budget.

4. Motivates managers to strive to achieve the budget goals

Budgeting gets managers to focus on participation in the budgeting process. It provides a challenge or target for individuals and managers by linking their compensation and performance versus budget.

5. Control activities

Managers can compare actual spending with the budget to control financial activities.

6. Evaluate the performance of managers

Budgeting provides a means of informing managers of how well they are performing in meeting targets they have set.

Who Reads a budget?

There are several good reasons to create a budget and to make it a good one. The reasons are tied to the people who will read and use the budget. Each reader will look at the budget in a different way and do something different with it. If you know your readers, you can make a budget that will impress everyone and, more important, show how your group is contributing to the organization and therefore approve the funds you need to proceed. If you know how the budget will be used, you will know how to write it in an easy-to-use way. More important, it will help you succeed and show that you are a good manager and that your team is doing a good job.

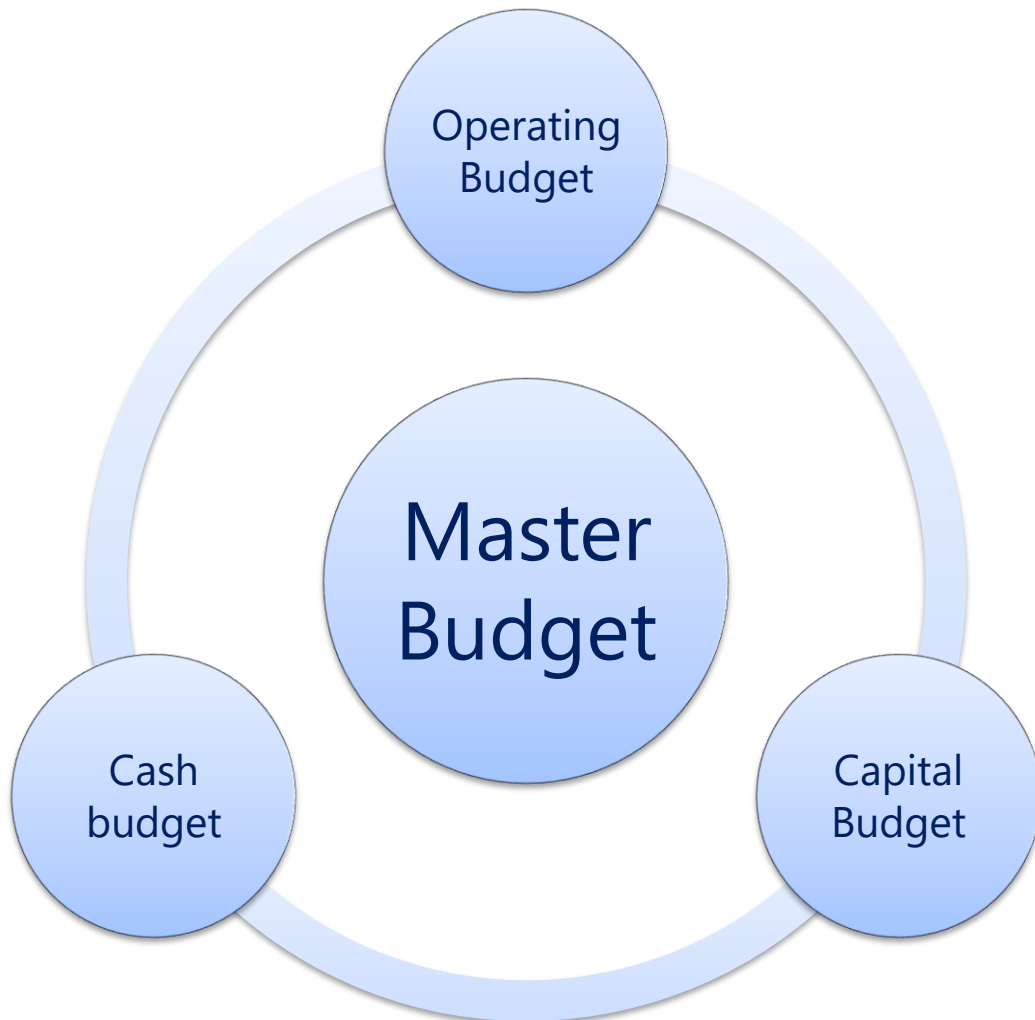
So, let's take a look at your audiences and what they will do with your budget.

- **You and Your Team** are your first, and most important, audience for your work plans and your budget. When you read the budget, you want it to make sense. This means that you understand it, of course, but it means more than that. The budget should be believable and workable and it should work the way your team works and be appropriate to your situation.
- **Your Boss (Management)** Your boss is your second audience. Of course, you want the budget to be correct, clear, and complete for him or her. If your boss checks your work

closely, you don't want any errors to show up. If your boss doesn't check it closely, you certainly don't want the budget to go further upstairs with mistakes in it. Your boss will also check the totals of the budget against available funds. In some companies and in many governments agencies, the boss will also check the budget against rules and limitations. Some organizations require that top managers approve the line-item budget.



The Most Important Types of Budget



The Operating budget

It shows the company's projected revenue and associated expenses for an upcoming period -- usually the next year -- and is often presented in an income statement format. Usually, management goes through the process of compiling the budget before the start of each year, and then makes ongoing updates each month.

To make it simple, an operating budget is a budget that tells the business owner how he and his advisors think his business will operate in the next 12 months.

An operating budget might consist of a high-level summary schedule, supported by detail to back up each line item in the budget.

An operating budget starts with revenue, and then shows each expense type. This includes variable costs, or the costs that vary with sales, such as the cost of raw materials and production labor. The operating budget includes fixed costs, such as the monthly rent on office space or the monthly payment for a photocopier lease. The budget also includes operating expenses, such as interest on business loans, and the non-cash expense of depreciation. These items enable the company to compute its projected net income and net profit percentage.

The Operating Budget is composed of a number of smaller budgets:

- **Sales Budget** - the expected product sales and the anticipated selling price per unit (during the budget period).
- **Production Budget** - the required number of units that must be produced to meet the expected sales.
- **Direct Materials Budget** - the materials required to meet production expectations.
- **Direct Labor Budget** - the labor required to meet production expectations.
- **Manufacturing Overhead Budget** – production facility expenses (during the budget period).
- **General and Administrative Budget** – expenses required to run the corporate office (during the budget period).

Example of Operating Budget

	Actual Expenditures 2017	Actual Expenditures 2018	Operating Budget 2019
Operational Income			
Revenue from operations	79,31,285	88,05,063	97,79,995
(Total : A)	79,31,285	88,05,063	97,79,995
Operational Expense	.	.	.
Cost of Goods Sold	39,65,643	44,02,532	48,89,998
Employee Benefit Expense – Salaries and Wages	24,84,144	28,18,135	30,81,575
Staff Welfare costs	1,17,411	1,18,488	1,13,843
Rent-Building	4,11,324	4,21,607	4,32,147
Professional Fees and Services	3,45,781	3,83,451	3,51,157
Rent-Machine and other	41,324	42,357	43,416
Travel	1,51,132	1,53,188	1,54,345
Marketing Expenses	50,305	53,123	54,054
(Total : B)	75,67,064	83,92,881	91,20,535
Profit before tax (A-B)	364,222	412,182	659,46

The Capital Budget

Capital budgeting is the process that a business uses to determine which proposed fixed asset purchases it should accept, and which should be declined. This process is used to create a quantitative view of each proposed fixed asset investment, thereby giving a rational basis for making a judgment.

The amount of cash involved in a fixed asset investment may be so large that it could lead to the bankruptcy of a firm if the investment fails. Consequently, capital budgeting is a mandatory activity for larger fixed asset proposals.

This is less of an issue for smaller investments; in these latter cases, it is better to streamline the capital budgeting process substantially, so that the focus is more on getting the investments made as expeditiously as possible; by doing so, the operations of profit centers are not hindered by the analysis of their fixed asset proposals.

There are a number of methods commonly used to evaluate fixed assets under a formal capital budgeting system. The more important ones are:

- **Net present value analysis.** Identify the net change in cash flows associated with a fixed asset purchase, and discount them to their present value. Then compare all proposed projects with positive net present values, and accept those with the highest net present values until funds run out.
- **Constraint analysis.** Identify the bottleneck machine or work center in a production environment and invest in those fixed assets that maximize the

utilization of the bottleneck operation. Under this approach, you are less likely to invest in areas downstream from the bottleneck operation (since they are constrained by the bottleneck operation) and more likely to invest upstream from the bottleneck (since additional capacity there makes it easier to keep the bottleneck fully supplied with inventory).

- **Payback period.** Determine the period required to generate sufficient cash flow from a project to pay for the initial investment in it. This is essentially a risk measure, for the focus is on the period of time that the investment is at risk of not being returned to the company.
- **Avoidance analysis.** Determine whether increased maintenance can be used to prolong the life of existing assets, rather than investing in replacement assets. This analysis can substantially reduce a company's total investment in fixed assets.

The Cash (Cash-Flow) Budget

A cash budget is an estimation of the cash inflows and outflows for a business over a specific period of time. This budget is used to assess whether the entity has sufficient cash to operate. Companies use sales and production forecasts to create a cash budget, along with assumptions about necessary spending and accounts receivable.

If a company does not have enough liquidity to operate, it must raise more capital by issuing stock or by taking on debt.

A cash flow budget is a useful management tool because it:

- Forces you to think through your plans to meet all your cash needs.
- Projects how much operating credit you will need and when projects when loans can be repaid.
- Helps you communicate your plans and credit needs to your lenders.

Cash Budget
For the Year Ending December 30, 2019

	Quarter				Year
	1	2	3	4	
Beginning Cash Balance	\$5,200	\$5,000	\$5,000	\$11,740	\$5,200
Add: Budgeted Cash Receipts:	37,150	54,190	53,730	62,300	207,370
Total Cash Available for Use	\$42,350	\$59,190	\$58,730	\$74,040	\$212,570
Less: Cash Disbursements					
Direct Material	14,960	16,550	16,810	19,410	67,730
Direct Labor	8,830	9,610	9,750	11,900	40,090
Factory Overhead	10,020	10,400	11,000	11,780	43,200
Selling and Admin. Expenses	7,640	8,360	8,500	9,610	34,110
Equipment Purchases		6,000		14,000	20,000
Total Disbursements	\$41,450	\$50,920	\$46,060	\$66,700	\$205,130
Cash Surplus/(Deficit)	\$900	\$8,270	\$12,670	\$7,340	\$7,440
Financing:					
Borrowing	4,100				4,000
Repayments		-3,188	-912		-4,000
Interest		-82	-18		-100
Net Cash from Financing	\$4,100	-\$3,270	-\$930		-100
Budgeted Ending Cash Balance	\$5,000	\$5,000	\$11,740	\$7,340	\$7,340

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Methods of Budgeting

There are four common types of budgets that companies use: (1) incremental, (2) activity-based, (3) value proposition, and (4) zero-based.

Incremental budgeting

Incremental budgeting takes last year's actual figures and adds or subtracts a percentage to obtain the current year's budget. It is the most common method of budgeting because it is simple and easy to understand. Incremental budgeting is appropriate to use if the primary cost drivers do not change from year to year. However, there are some problems with using the method:

It is likely to perpetuate inefficiencies. For example, if a manager knows that there is an opportunity to grow his budget by 10% every year, he will simply take that opportunity to attain a bigger budget, while not putting effort into seeking ways to cut costs or economize.

It is likely to result in budgetary slack. For example, a manager might overstate the size of the budget that the team actually needs so it appears that the team is always under budget.

It is also likely to ignore external drivers of activity and performance.

For example, there is very high inflation in certain input costs. Incremental budgeting ignores any external factors and simply assumes the cost will grow by, for example, 10% this year.

Advantages of Incremental Budgeting:**Limitations of Incremental Budgeting:**

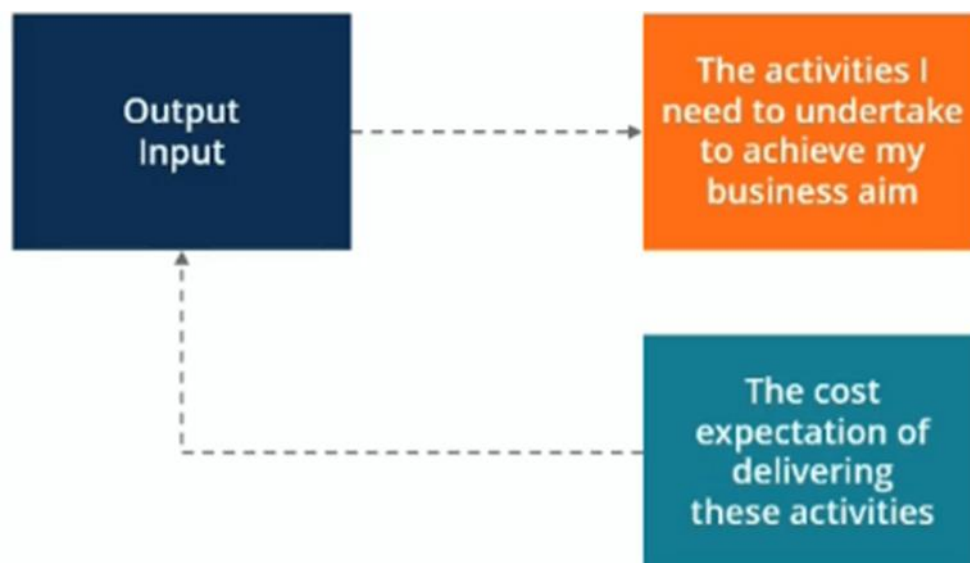
- It usually is incremental in nature since it assumes that this year's requirement is likely to be marginally different from the previous year. However, in reality, there may be major structural changes with respect to the company, industry or economy which may warrant much more significant budget changes.
- This approach may tend to make managers spend more as budgets may be easily available and may lead to unnecessary spending of funds which may not be warranted.
- Since this method assumes a slight change in budgetary allocations from prior period, it assumes that method of working shall remain the same. This may lead to the lack of innovation and no incentive for managers to reduce the cost.
- Incremental budgeting subconsciously encourages higher spending so that the budget is maintained next year.
- Incremental budgeting may cause management to lead into a scenario called as budgetary slack, whereby managers tend to build lower revenue growth and higher expense growth so as to have favorable variances.

- “Disconnect from reality” is what is frequently seen in cases of incremental budgeting as actual results many times tend to be different from budgeted as budgets were based on a prior year benchmark and not on projected/forecast requirements.
- Incremental budgeting can cause perpetual resource allocation to certain departments even if they may not require them in later years

Activity Based Budgeting

Activity based budgeting is a budgeting method in which budgets are prepared using Activity Based Costing after considering the overhead costs. In simple words, activity based budgeting is management accounting tool which does not consider the past year's budget to arrive at current year's budget. Instead, the activities that incur the cost are deeply analyzed and researched. Based on the outcome of the study, the resources are allocated to an activity.

Activity based budgeting is carried out to bring efficiency in the activities of an organization. Budgets are prepared after justifying the cost drivers. Thus, activity based budgeting is activity oriented and not function oriented.



Advantages of Activity Based Budgeting

- It **evaluates** each and every cost driver. It takes into consideration all the steps involved in an activity. The irrelevant activities are eliminated and only the necessary activities form a part of the business.
- Activity based budgeting system eliminates all sorts of unnecessary activities, which helps the business to save its costs. The saved cost results in the production of goods and services at lower cost than that of competitors. It also helps the organization to gain a **competitive edge** in the market.
- This budgeting technique helps in viewing the **business as a single unit** and not in the form of departments. The managers or the top management prepare the budget for the business unit as a whole and not keeping in mind any single department as done in the case of other methods of budgeting.

- Budgets under activity based budgeting are prepared after deep research and analysis. This study **removes all the unnecessary activities** of the business. By doing so, the business eliminates all sorts of **bottlenecks** associated with an activity and business functions are carried out more smoothly
- Activity based budgeting system helps in **improving the relationship** between the organization and its customers. The main aim of this budgeting method is to eliminate unnecessary activities and serve the customers with the best quality at best price. This enforces (indirectly) the employees of the company to serve the customers in the best way possible and ensure customer satisfaction. In turn, the relationship between the organization and the customers improves.

Limitations of the Activity Based Budgeting

- Activity-based budgeting **requires a deep understanding** of various functional areas of the business. If the manager preparing the budget is incapable of understanding and evaluating the areas of business, it would lead to inaccurate budget preparation.
- It is **complex** in nature. It requires research and analysis of various factors. This budgeting method comprises of estimation of demand and based on that, it does the estimation of resources to be employed in various activities.
- The process of budgeting in this method **consumes a lot of resources** of an organization. It needs to employ top officials for conducting numerous

analyses. It is a very time-consuming task too. If these resources are employed in other operational activities, they can give better returns.

- Implementation of activity-based budgeting **requires trained employees**. An employee, who is not trained enough, cannot handle the budgeting exercise effectively. So business needs to **incur extra costs** to train its employees. Moreover, the process requires the involvement of top management, so proves to be costly too.
- Activity-based budgeting focuses on **short-term goals** of the business. It does not take into account the long-term scenario of the business. Focusing more on short-term goals rather than long-term goals can prove to be very fatal for the organization.

Value Proposition Budgeting

In value proposition budgeting, the budgeter considers the following questions:

- Why is this amount included in the budget?
- Does the item create value for customers, staff, or other stakeholders?
- Does the value of the item outweigh its cost? If not, then is there another reason why the cost is justified?

Value proposition budgeting is really a mindset about making sure that everything that is included in the budget delivers value for the business. Value proposition budgeting aims to avoid unnecessary expenditures.

Example:

“How much should be spent on marketing?” “What’s the average marketing budget?”

Fair questions but the answer is going to vary, based on a lot of factors, e.g. the size of your business and how much import you place on marketing. Some folks say companies should spend 5% of their total revenue on marketing, just to maintain their current position in the marketplace. Some say If you’re looking to grow you should budget more like 10% of your revenue.

Zero-Based Budgeting

Zero-based budgeting (ZBB) is a budgeting technique that allocates funding based on efficiency and necessity rather than on budget history. Management starts from scratch and develops a budget that only includes operations and expenses essential to running the business; there are no expenses that are automatically added to the budget.

All expenses must be justified in order to qualify to be placed in the budget. For example, if a company expects to incur \$100,000 in salaries and wages expenses, and believes that the full \$100,000 is absolutely necessary to operate the business

smoothly, then it will be included in the budget – however, each individual allotment of salary/wages has to be examined and justified in order to be included.

If instead of paying some salaries, the company's management determines that it can substitute technology – and at a lower cost – then adjustments to the budget are made accordingly.

All businesses use budgets to keep track of expenses and improve ways to minimize costs and maximize profit. Budget planning for the current/next year is usually based on budgets from previous years. In fact, traditional budgeting begins with the previous year's budget and usually implements incremental percentage increases or decreases to meet new goals. These percentages usually range anywhere from 1% to 10%.

Sometimes, budgets can get out of control, or in some years may show significantly higher or lower costs, depending on the overall market outlook and other external factors. In these scenarios, it does not make sense to simply look at last year's budget, because significant changes in the company's situation have taken place. The entire budget needs to be redone from scratch, hence, a zero-based budget.

In a zero-based budget, the company analyzes every expense/aspect of the business one by one. This is referred to as starting from a "zero base." While zero-based budgeting examines all expenses, traditional budgeting only examines proposed new expenses.

Advantages of Zero-Based Budgeting:

- Traditional budgeting considers the fact that “how much” expense shall be incurred. However, zero-based budgeting is on “why” approach. It goes to the root of the expense. Zero-based budgeting aims towards **achieving** the objectives of the organization. For better decisions, Zero-based budgeting completely ignores the past years’ figures.
- Zero-based budgeting aims at **cost-benefit analysis**. It does not focus on studying the changes in expenses and preparing a variance analysis (such as why the expenses increased or reduced). However, it considers the necessity of the expense and the benefit which will be derived from the expense. In order to prepare an effective zero-based budget, more and accurate information is a must. Zero-based budgeting operates vertically as well as horizontally. And hence it enables all the levels of management to participate in the decision-making process of the organization.
- The ultimate objective of any organization is to maximize the profitability of the organization and enhancing the wealth of the shareholders. The zero-based budget helps in achieving this objective. Zero-based budgeting ensures that the resources of the organizations are economically and **efficiently** allocated.
- For each year, the preparation of the zero-based budgeting is with the same assumption of not taking a base for any previous period. Each department of the organization analyzes the expenses every year. They make sure that there is

an inclusion of only those expenses in ZBB which are necessary and which derive benefits.

- At first, the zero-based budget identifies all the **obsolete processes** of the manufacturing unit or other departments of the organization. If the process is not essential for the organization, the same has to be analyzed and scrapped by the management. Discontinuation of obsolete operation results in better costing, better pricing and better profitability of the organization. Zero-based budgeting helps in enhancing the interpretation and knowledge of different cost patterns.

Limitations of Zero-Based Budgeting

- **Damaging to the Long Term Goal.** it is based on a cost and benefit analysis of a particular period. In the short run, the company may not get benefit in the same year of incurring the expenses. However, some of the expenses which have to be incurred for achieving the long-term goals of the organization.
- **Rigidity.** The organization should not always stick to the budget in every situation. Sometimes circumstances may arise which lead the management to incur the expense of the unexpected opportunity or to mitigate the possible threat.
- **Skills & Managerial Conflict.** Management conflicts may arise since the zero-based budgeting requires a large amount of time and efforts of the managerial

and executive staff. Sometimes, the required skills are also not present in the staff for preparation of zero-based budgets

Levels of Involvement in Budgeting Process

We want buy-in and acceptance from the entire organization in the budgeting process, but we also want a well-defined budget and one that is not manipulated by people. There is always a trade-off between goal congruence and involvement.



Imposed budgeting

Imposed budgeting is a top-down process where executives adhere to a goal that they set for the company. Managers follow the goals and impose budget targets for activities and costs. It can be effective if a company is in a turnaround situation where they need to meet some difficult goals, but there might be very little goal congruence.

Negotiated budgeting

Negotiated budgeting is a combination of both top-down and bottom-up budgeting methods. Executives may outline some of the targets they would like hit, but at the same time there is shared responsibility for budget preparation between managers and employees. This increased involvement in the budgeting process by lower level employees may make it easier to adhere to budget targets, as the employees feel like they have a more personal interest in the success of the budget plan.

Participative budgeting

Participative budgeting is a roll-up approach where employees work from the bottom up to recommend targets to the executives. The executives may provide some input, but they more or less take the recommendations as given by department managers and other employees (within reason, of course). Operations are treated as autonomous subsidiaries and are given a lot of freedom to set up the budget.

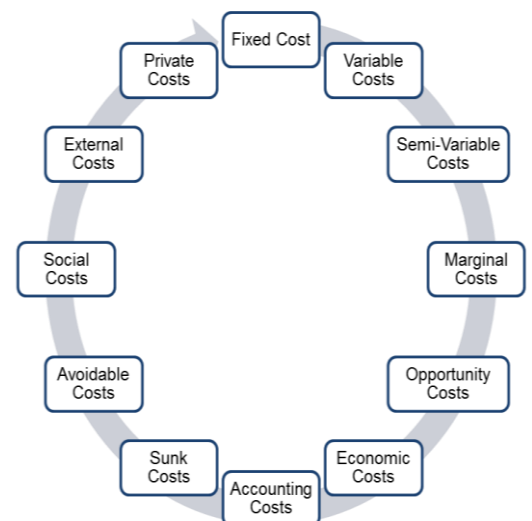
Understanding Cost & Income

The Major Types of Cost

- **Fixed Costs (FC).** The costs which don't vary with changing output. Fixed costs might include the cost of building a factory, insurance and legal bills. Even if your output changes or you don't produce anything, your fixed costs stay the same.
- **Variable Costs (VC).** Costs which depend on the output produced. For example, if you produce more cars, you have to use additional raw materials such as metal. This is a variable cost.
- **Semi-Variable Cost.** Labor might be a semi-variable cost. If you produce more cars, you need to employ more workers; this is a variable cost. However, even if you didn't produce any cars, you may still need some workers to look after empty factory.
- **Total Costs (TC):** Fixed + Variable Costs

Cost	Variable	Fixed
Depreciation of executive jet		X
Cost of shipping finished goods to customers	X	
Wood used in manufacturing furniture	X	
Sales manager's salary		X
Electricity used in manufacturing furniture	X	
Packing supplies for shipping products	X	
Sand used in manufacturing concrete	X	
Supervisor's salary		X
Advertising costs		X
Executive's life insurance		X

- **Marginal Costs:** Marginal cost is the cost of producing an extra unit. If the total cost of 3 units is 1550, and the total cost of 4 units is 1900. The marginal cost of the 4th unit is 350.
- **Opportunity Cost:** Opportunity cost is the next best alternative foregone. If you invest \$1million in developing a cure for pancreatic cancer, the opportunity cost is that you can't use that money to invest in developing a cure for skin cancer.
- **Economic Cost.** It includes both the actual direct costs (accounting costs) plus the opportunity cost. For example, if you take time off work to a training scheme. You may lose a week's pay of \$350, plus also have to pay the direct cost of \$200. Thus the total economic cost = \$550.
- **Accounting Costs:** This is the monetary outlay for producing a certain good. Accounting costs will include your variable and fixed costs you have to pay.
- **Sunk Costs:** These are costs that have been incurred and cannot be recouped. If you left the industry, you could not reclaim sunk costs. For example, if you spend money on advertising to enter an industry, you can never claim these costs back. If you buy a machine, you might be able to sell if you leave the industry.



- **Avoidable Costs:** Costs that can be avoided. If you stop producing cars, you don't have to pay for extra raw materials and electricity. Sometimes known as an escapable cost.

Understanding CAPEX & OPEX

Capital expenditures (CAPEX) and operating expenses (OPEX) represent two categories of business expenses. However, there are distinct differences between the two and their respective tax treatments.

Capital expenditures are the amounts that companies use to purchase major physical goods or services that will be used for more than one year. For example, a company might have capital expenditures to increase or improve its fixed assets. Fixed assets are treated as noncurrent assets from an accounting standpoint, meaning they won't be consumed in the first year.

Capital expenditures might include:

- Plant and equipment purchases
- Building expansion and improvements
- Hardware purchases, such as computers
- Vehicles to transport goods

The type of industry a company is involved in largely determines the nature of its capital expenditures. The asset purchased may be a new asset or something that improves the productive life of a previously purchased asset.

The capital expenditure is recorded as an asset on the balance sheet under the section "property, plant & equipment." However, it's also recorded on the cash flow statement under "investing activities," since it's a cash outlay for that accounting period.

Once the asset is being used, it's depreciated over time to spread the cost of the asset over its useful life. In other words: Each year, a part of the fixed asset is being used up. Depreciation represents the amount of wear and tear on the fixed asset, and the amount of depreciation for each year can be used as a tax deduction. In general, capital expenses are most often depreciated over a five to 10-year period, but may be depreciated over more than two decades in the case of real estate.

Operating expenses are the costs for a company to run its business operations on a daily basis. Examples include:

- Rent
- Utilities
- Salaries and pension plan contributions
- Any expense considered sales, general, & administrative expenses or SG&A on the income statement
- Research & development
- Property taxes
- Business travel

As operational expenses make up the bulk of a company's regular costs, management typically looks for ways to reduce operating expenses without causing a critical drop in quality or production output. In contrast to capital expenditures, operating expenses are fully tax-deductible in the year they are made.

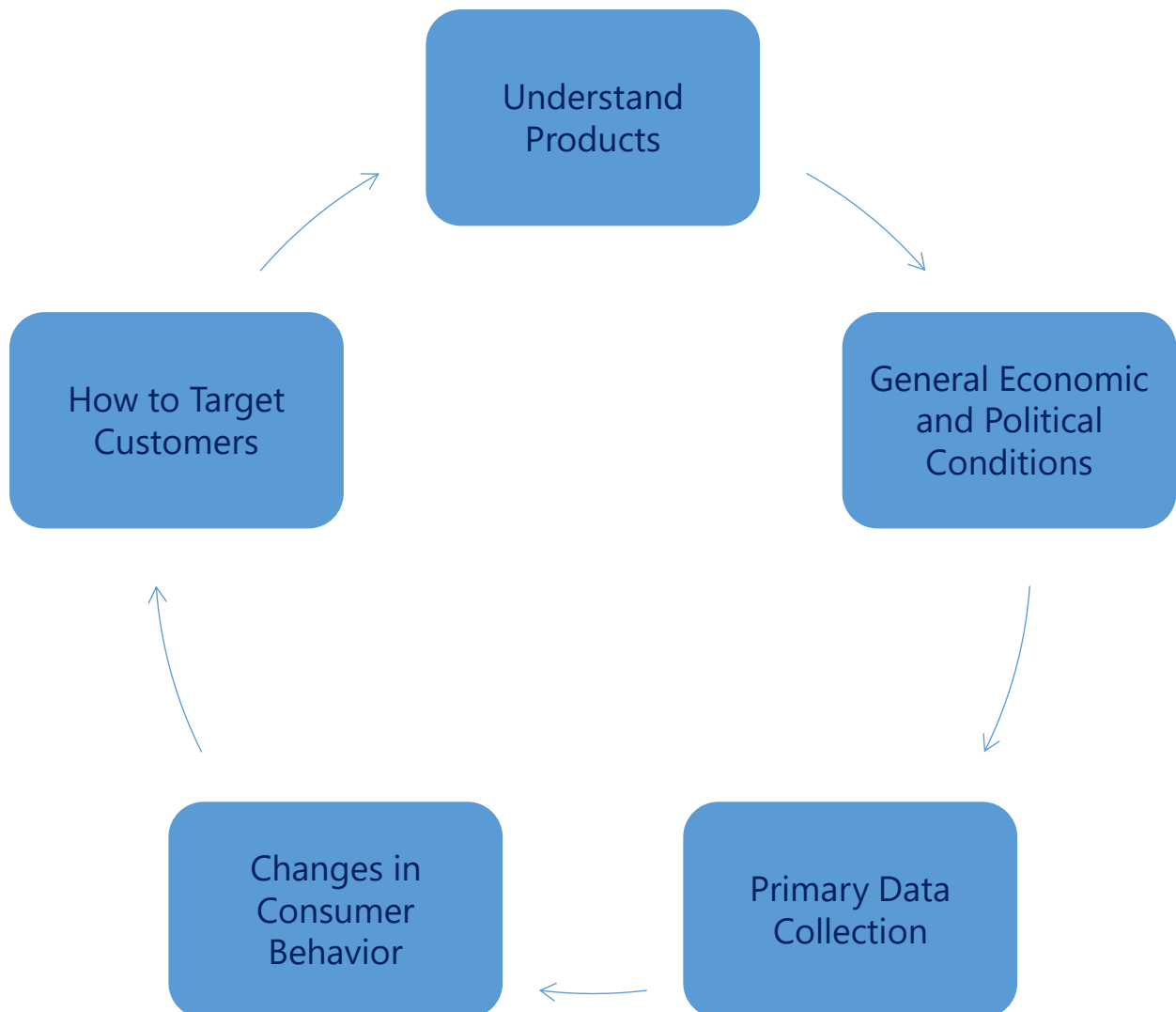
It's important to note that sometimes an item that would ordinarily be obtained through capital expenditure can have its cost assigned to operating expenses if a company chooses to lease the item rather than purchase it. This can be a financially attractive option if the company has limited cash flow and wants to be able to deduct the total item cost for the year.

The Bottom Line

Capital expenditures are major purchases that will be used in the future. The life of these purchases extends beyond the current accounting period in which they were purchased. Because these costs can only be recovered over time through depreciation, companies ordinarily budget for CAPEX purchases separately from preparing an operational budget.

The OPEX represent the other day-to-day expenses necessary to keep the business running. These are short-term costs and are used up in the same accounting period in which they were purchased.

When it comes to budgeting, the key indicator is market intelligence. Understanding our clients is a basic key success indicator. In order to understand how to expand, we can do the following:



Example of an Income Statement (Exercise 2)

MF Institute		
	Year 2	Year 1
Sales 1	\$3,103,654	\$2,413,549
Sales 2	\$56,411	\$142,632
Sales 3	\$650,059	\$488,291
	\$3,810,124	\$3,044,471
Doubtful Account	(\$147,325)	(\$82,930)
Financial charges (net)	(\$150,767)	(\$175,694)
Net revenue	\$3,512,032	\$2,785,847
Other income	\$17,674	\$7,595
	\$29,851	\$170,527
Grants received from HQ		
	\$3,559,557	\$2,963,969
Staff costs	(\$1,984,740)	(\$1,617,615)
Operating expenses	(\$1,068,781)	(\$884,509)
Depreciation and amortization	(\$169,048)	(\$101,061)
	(\$3,222,569)	(\$2,603,185)
Profit before tax	\$336,988	\$360,783
Income tax	\$ -	\$ -
Profit for the year	\$336,988	\$360,783
Other comprehensive income	\$ -	\$ -
Total comprehensive profit for the year	\$336,988	\$360,783

Budgeting Process & Controls

Before we start any corporate budget, we need to:

- Identify Management's Considerations
- Identify Our Departmental Considerations based on the 8 steps
- Negotiate with the Budget Committee
- Get the Budget Approved
- Design Process and Methods
- Design Authorization Methods
- Collect Feedback and then Restart



8 Steps for a Head of Department

➤ **Step 1: Gathering Information.**

The first job is to gather accurate information about the past. This is not always easy. Sometimes, records are not kept well. Often, we need to project next year's budget before this year is over or before the information on this year's expenses is ready. Sometimes, we can find out what we spent, but we can't get the answer to the magic question: Why?

➤ **Step 2: Understanding Each Line.**

Preparing a good budget is detail work. We need to do more than say, "I guess we'll spend the same next year." We need to know why we spent what we did and think about what will change. So we examine each line and, using our own memory, meetings with others, and reviews of receipts and contracts, we understand why we spent what we did.

➤ **Step 3: Predicting the Future.**

Unless you have a working crystal ball, the best way to predict the future is to picture it, meet with people about what they want and what's happening, and then make an estimated or calculated guess. Your guess will be the best one possible because it's based on good information, your own experience, careful thinking, and accurate calculations. New managers are often afraid of writing down a lot of guesses and giving them to their boss. That's understandable. But

that's all anybody ever does when predicting the future. Reasonable and calculated guesses are the best we can do for budgeting.

➤ **Step 4: Reviewing the Results**

- ✓ Does it make sense? For each item, do the numbers look right? Think about the decision you've made and make sure you're comfortable with it. If not, then get someone's opinion or rethink it yourself.
- ✓ Does it add up? Even if you use a computerized spreadsheet, you'll want to check your numbers.
- ✓ Are the big items right? Pay more attention to the line items with higher figures. If any aren't done, finish those first, using the same methods you used in Step 3.

➤ **Step 5: Finishing the Budget**

Once you complete the larger line items, you need to finish up the smaller ones. It doesn't matter too much how you do it.

➤ **Step 6: Adding Budgetary Assumptions**

A budget is more than just numbers. Your sources of information and reasoning are important as well. With this information, you and others can review the budget, improve it, and easily extend it into the future. And, if errors appear, it's possible to trace the source of the mistakes. Perhaps your planning was right, but you were given the wrong information to begin with. We put all this

information into a one- or two-page document. Keep it short and simple. They should be as simple as:

***Equipment leases:** Costs lowered because one of three units will be purchased in 1/2019.

****Equipment purchase:** Increase due to execution of buy option on leased photocopy machine.

*****All supply items:** 20% increase based on discussions with customers about expected growth in demand for services.

➤ **Step 7: Checking Your Work**

You are almost ready to present your budget. But you are probably a bit nervous—and you should be! You don't want to have someone else find your mistakes after you've delivered your budget. So, the best thing is to find those mistakes now and have someone else help you do it. You need to do more than check your numbers. Capitalization, spelling, punctuation, and grammar are also important. And it never hurts to take a few extra minutes to make a document look good with stylish, professional fonts and formatting.

➤ **Step 8: Delivering Your Budget**

With your team, focus on how you came up with the figures and how you expect the team to spend money and track expenses through the year. Help them be responsible about tracking money and let them know you support them in

having what they need to do their job. Your manager is likely to want to go over the budget carefully before it goes to accounting and finance. It's good to make the time to sit down with him or her and review your assumptions. Your manager may also want to change some items.

Here is your Check-List

Step 1: Gathering Information

Step 2: Understanding Each Line

Step 3: Predicting the Future

Step 4: Reviewing the Results

Step 5: Finishing the Budget

Step 6: Adding Budgetary Assumptions

Step 7: Checking Your Work

Step 8: Delivering Your Budget

Example of Departmental Budgeting

in thousands LBP	ACTUAL 31/12/2019	BUDGETED	BUDGETED	BUDGETED
		(Can Be Controlled) 31/12/2020	31/12/2021	31/12/2022
Furniture	8,428,696	7,886,000	8,950,000	9,850,000
Equipment**	9,788,525	9,850,000	10,850,000	11,850,000
Computers**	8,885,658	9,350,000	9,850,000	10,350,000
Software *	10,089,151	-	-	-
Vehicles	698,817	700,000	710,000	720,000
Decoration and Building Repair	8,358,934	10,350,000	10,350,000	10,350,000
Leased hold improvement**	16,802,470	17,150,000	17,500,000	17,850,000
Advance on work	5,103,507	2,350,000	2,350,000	2,350,000
Advance on Fixed Assets	2,910,947	2,911,000	2,911,000	2,911,000
Advance on work Project 2**	1,094,854	1,650,000	4,350,000	5,900,000

* Discuss with the Concerned Department

** The above assumption takes the following points into consideration

Furniture

- Renovating 2 branches per year where the assumed furniture cost per branch is USD //30,000// thus the estimated total cost is USD //60,000//
- New Branch per year where the assumed furniture total cost of USD //30,000//
- Replacing damaged furniture for branches assuming total cost of USD //5,000//

Equipment

- 3 generators per year for an assumed total cost of USD //60,000//
- 5 UPS per year for an assumed total cost of USD //25,000//
- ACs for an assumed total cost of USD //15,000//

The Three Basic Points in Justifying Your Budget

1. The value will exceed the cost. That is, the benefit of spending the money and doing the work is greater than the cost of the budget.
2. The work plan fits within the company's long-term plans and does the work that the department or project is expected to do.
3. You've made a good effort to reduce costs. That is, you're spending as little money as possible to get the work done well with quality materials.

A Major Method of Control

in thousands LBP	ACTUAL	BUDGETED	Variation	% Variation	Comments
	31/12/2019	31/12/2020			
Furniture	8,428,696	7,886,000	-542,696	-6%	
Equipment	9,788,525	9,850,000	61,475	1%	
Computers	8,885,658	9,350,000	464,342	5%	
Software	10,089,151	110,000	0	-99%	
Vehicles	698,817	700,000	1,183	0%	
Decoration and Building Repair	8,358,934	10,350,000	1,991,066	24%	
Leased hold improvement	16,802,470	17,150,000	347,530	2%	
Advance on work	5,103,507	2,350,000	-2,753,507	-54%	
Advance on Fixed Assets	2,910,947	2,911,000	53	0%	
Advance on work Project	1,094,854	1,650,000	555,146	51%	