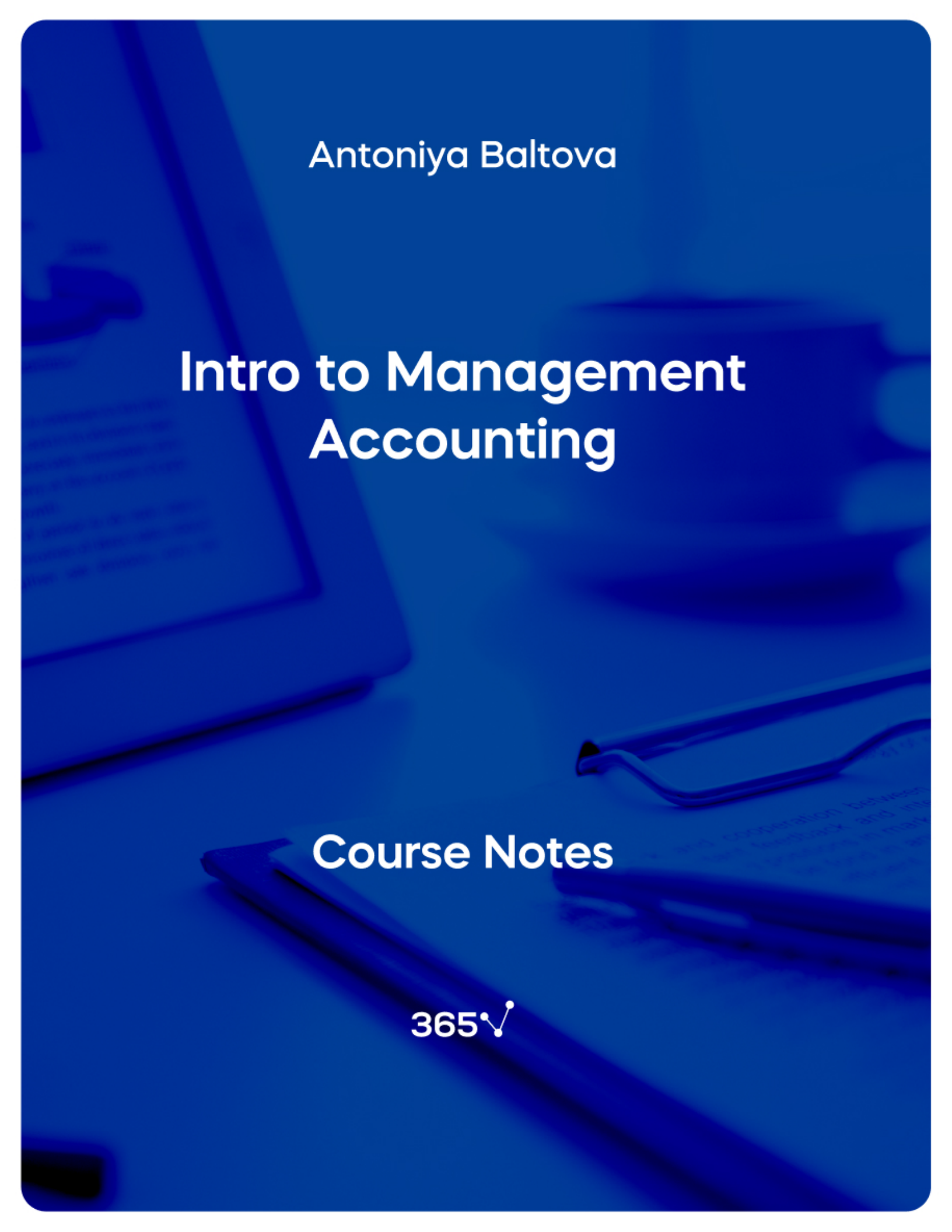




Antoniya Baltova

Intro to Management Accounting

Course Notes

365✓

Table of Contents

1. Introduction to Management Accounting	4
1.1 What Is Management Accounting?	4
1.2 Nature and Purpose of Management Accounting	4
1.3 The Managerial Processes of Planning, Decision-Making, and Control	5
1.4 Strategic vs Tactical vs Operational Planning	6
1.5 Management Accounting vs Financial Accounting	7
2. Cost Concepts and Classification	8
2.1 Cost Classification Basics	8
2.2 Production vs Non-Production Costs	9
2.3 Costs by Function vs Costs by Nature	9
2.4 Direct vs Indirect Costs	9
2.5 Fixed vs Variable vs Stepped Costs	9
3. Cost-Volume-Profit (CVP) Analysis	10
3.1 What is CVP Analysis?	10
3.2 Contribution Margin and Break-Even Point	10
3.3 Margin of Safety	10
3.4 Target Profit	10
4. Cost Accounting Techniques	11
4.1 Cost Accounting Techniques Overview	11
4.2 Materials Cost Accounting	12
4.3 Labor Cost Accounting	12
4.4 Overheads Cost Accounting	14
4.5 Marginal vs Absorption Costing	14
4.6 Calculating Profits under Marginal and Absorption Costing	15
5. Budgeting Basics	16
5.1 Why Do Companies Need Budgets?	16
5.2 The Importance and Benefits of Budgeting	16
5.4. The Master Budget	18
5.5 Budgeting Techniques	19
5.6 Budgeting vs Forecasting	22
5.7 Budgeting Control and Variance Analysis	22

6. Standard Costing and Variance Analysis	24
6.1 Understanding Standard Costs	24
6.2 Standard Costing Benefits and Limitations.....	24
6.3 Variance Analysis Overview	25
6.4 Sales Variances	25
6.5 Material Variances.....	26
6.6 Labor Variances	26
6.7 Total Variable Overhead Variances.....	26
6.8 Reconciliation between Standard and Actual Profit	26
7. Performance Measurement & Control	27
7.1 Performance Measurement – Overview	27
7.2 Key Performance Indicators (KPIs)	27
7.3 Balanced Scorecard	29
7.4 Performance Control Systems	29
7.5 Benchmarking	30
GLOSSARY	31

1. Introduction to Management Accounting

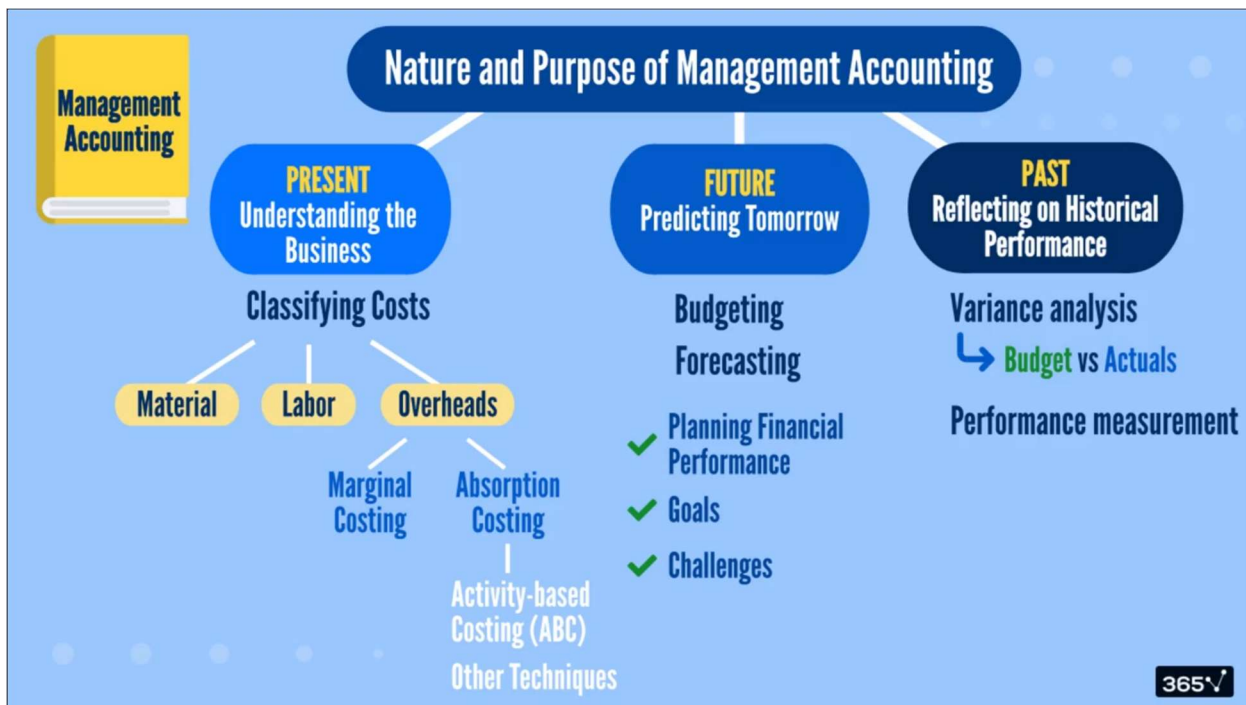
1.1 What Is Management Accounting?

Management Accounting involves collecting, analyzing, interpreting, and presenting financial information for managers to use internally for planning, decision-making, and overall control. It supports the management team by providing reports on strategic direction, operational control, and performance monitoring.

1.2 Nature and Purpose of Management Accounting

The **role** of management accountants is essential because they provide critical financial data and analysis for planning, controlling, and strategic decision-making.

The primary **purpose** of management accounting is to optimize the organization's economic efficiency—maximizing profits and shareholder value.



1.3 The Managerial Processes of Planning, Decision-Making, and Control

Planning

The managerial planning process entails defining goals and mapping out strategies—incorporating budgeting and forecasting.

Decision-Making

Utilizing relevant financial data enables informed decision-making between alternatives through cost-benefit analysis and risk assessment.

Control

The control process ensures the organization's strategic objectives are on track by monitoring performance against budgets and standards and implementing corrective actions when necessary.



1.4 Strategic vs Tactical vs Operational Planning

Strategic Planning

Focused on long-term core business goals, such planning sets the company's direction for three to five years.

Tactical Planning

This type of planning implements components of a strategic plan over one to three years, focusing on shorter-term actions.

Operational Planning

This category involves detailed, short-term guidance for daily operations, typically spanning a year or less.



1.5 Management Accounting vs Financial Accounting

Management accounting differs from **financial accounting** in several aspects, including purpose, audience, perspective, insights, reporting requirements, and regulations.

365✓Financial Analyst		
MANAGERIAL ACCOUNTING		VS
		FINANCIAL ACCOUNTING
 Purpose	Assists management in planning, controlling business operations, and decision-making .	Records a business's historical transactions to reflect its financial performance.
 Audience	Internal users: Specifically tailored for the company's decision-makers, management, and business owners.	External users: Primarily shareholders, lenders, regulators, and other stakeholders.
 Perspective	Forward-looking: focusing on future planning and strategies.	Backward-looking: concentrating on past transactions and performance.
 Insights	Provides strategic insights to guide internal decision-making.	Offers analytical insights based on historical data for external evaluation.
 Information Type	Includes financial and non-financial information , catering to a broader internal strategy and operations scope.	Predominantly financial information , focusing on quantifiable data that conforms to accounting standards.
 Reporting Standards	No universally recognized standards; practices are adaptable based on internal requirements.	Must adhere to such recognized standards as International Financial Reporting Standards (IFRS), US Generally Accepted Accounting Principles (US GAAP), or other local GAAP.
 Legal Requirements	There are no legal mandates for the preparation of managerial accounting information; practices are determined by internal policy.	Subject to legal and regulatory requirements for preparing and presenting financial statements, varying by jurisdiction.
 Reporting Frequency	Flexible and based on the company's needs, it can range from daily to monthly and include ad-hoc reports for specific purposes.	Structured and periodic , typically annually or semi-annually, by regulatory and stakeholder requirements.
 Skillset and Education	Requires analytical thinking, strategic planning skills , and often an educational background in managerial accounting or business administration.	Requires detailed knowledge of accounting principles and regulations , and typically an accounting or finance degree.
 Technology and Tools	Utilizes advanced analytics, budgeting, and forecasting software to support strategic planning and decision-making.	Relies on accounting software and systems that ensure compliance with accounting standards and facilitate efficient financial reporting.
 Key Challenges	Adapting to rapidly changing business environments and strategic priorities , providing timely and relevant insights for decision-making.	Keeping up with changes in regulatory standards and ensuring accurate and compliant financial reporting.
 Career Path	Can progress from internal reporting roles to strategic planning positions , such as Chief Financial Officer (CFO) or strategic advisor.	Can lead to such positions as a public accountant, audit specialist, or CFO , with a strong focus on compliance and reporting.
365✓Financial Analyst		
 FOLLOW US ON LINKEDIN		 SHARE THIS POST

2. Cost Concepts and Classification

2.1 Cost Classification Basics

BASICS OF CLASSIFICATION	
 Relationship to the cost object	Direct Costs: Can be directly traced to a cost object, such as a product, project, or department. Indirect Costs: Cannot be traced directly to a cost object and are therefore allocated, such as factory rent, insurance, and utilities.
 Function	Production Costs: Incurred during the manufacturing or production process and include direct materials, direct labor, and manufacturing overhead. Non-Production Costs: Costs that cannot be directly linked to the production process, including selling expenses and administrative expenses.
 Nature	Materials: The raw inputs that are converted into finished goods. Labor: The human effort required to manufacture a product. Overheads: Costs related to production that are not direct materials or direct labor, such as rent for the factory, depreciation of equipment, and utilities.
 Behavior	Fixed Costs: Do not change with the level of production or sales volume, such as rent, salaries, and insurance. Variable Costs: Change in proportion to the level of production or sales volume, such as raw materials and sales commissions. Stepped Costs: Remain fixed over a range of activity but change (step up or down) once that range is exceeded, such as the cost of additional machinery or personnel when production capacity is increased.
 Controllability	Controllable Costs: Costs that can be influenced or controlled by a manager. Uncontrollable Costs: Costs that cannot be influenced or controlled by a manager.
 Place in the Production Process	Batch Costs: Costs incurred for a batch of goods, including setup and preparation costs. Process Costs: Costs incurred for continuous production processes.
 Time Period	Historical Costs: Costs that have been incurred in the past. Estimated Costs: Costs that are predicted or budgeted to be incurred in the future.
 Relevance to Decision-making	Relevant Costs: Costs that will affect future decisions. Irrelevant Costs: Costs that will not affect future decisions. Sunk Costs: Costs that have already been incurred and cannot be recovered.

2.2 Production vs Non-Production Costs

Production costs are incurred during manufacturing, including direct materials, labor, and overheads.

- **Materials:** These are the raw inputs transformed into finished goods—either direct (raw materials) or indirect (not directly traceable to the final product).
- **Labor:** The human effort needed to create a product, like materials, can be direct (hands-on manufacturing) or indirect (supporting production).
- **Overheads:** This includes production costs like factory rent, equipment depreciation, and utilities, excluding direct materials and labor.

Non-production costs encompass selling and administrative expenses unrelated to production.

- **Selling Costs:** These are expenses related to marketing, distribution, and product sales, such as advertising and shipping.
- **General Costs:** Such Expenses include those related to the broad operations of the business—such as executive salaries—and are not specific to any one function.
- **Administrative Costs:** These costs are associated with the general administration of the business, like office supplies and clerical salaries.
- **Finance Costs:** This category includes expenses related to the company's financing, including interest payments.

2.3 Costs by Function vs Costs by Nature

- **By Function:** Costs are classified based on the department or segment of the business, such as production, research, and marketing.
- **By Nature:** Costs are categorized according to their nature—e.g., salaries, rent, and utilities—and can be further categorized into fixed, variable, or mixed costs.

2.4 Direct vs Indirect Costs

- **Direct costs** can be directly traced to a cost object (e.g., a product, project, or department).
- **Indirect costs**—such as factory rent, insurance, and utilities—cannot be traced directly to a cost object and are, therefore, allocated.

2.5 Fixed vs Variable vs Stepped Costs

- **Fixed costs** like rent, salaries, and insurance do not change with the production or sales volume level.
- **Variable costs**—such as raw materials and sales commissions—change proportionally to the production or sales volume level.
- **Stepped costs** are fixed within certain activity levels but adjust (increase or decrease) when these levels are exceeded—e.g. when extra machinery or staff are needed as production capacity grows.

3. Cost-Volume-Profit (CVP) Analysis

3.1 What is CVP Analysis?

The primary purpose of CVP analysis is to understand how changes in cost and volume affect a company's profit.

3.2 Contribution Margin and Break-Even Point

Contribution Margin:

Contribution Margin (CM) = Sales Revenue – Variable Costs (VC)

$$\text{Contribution Margin Ratio} = \frac{\text{Contribution Margin}}{\text{Sales Revenue}}$$

Break-even Point: The point where total revenue equals total costs, resulting in neither profit nor loss.

$$\text{Break – even Point (units)} = \frac{\text{Total Fixed Costs}}{\text{Selling Price per Unit – Variable Cost per Unit}}$$

$$\text{Break – even Point (dollars)} = \frac{\text{Total Fixed Costs}}{\text{Contribution Margin Ratio}}$$

3.3 Margin of Safety

Margin of Safety: This is the amount by which sales can drop before reaching the break-even point.

Margin of Safety (units) = Current Sales (units) – Break – even Sales (units)

Margin of Safety (\$) = Current Sales – Break – even Sales

$$\text{Margin of Safety (\%)} = \frac{\text{Current Sales} - \text{Break – even Sales}}{\text{Current Sales}} \times 100$$

3.4 Target Profit

Profit = Contribution Margin – Total Fixed Costs

$$\text{Number of Units to be Sold} = \frac{\text{Total Fixed Costs} + \text{Target Profit}}{\text{Contribution Margin per Unit}}$$

4. Cost Accounting Techniques

4.1 Cost Accounting Techniques Overview

Costing Systems are the methods used to allocate production costs to products or services. The choice of system affects how costs are tracked and managed.

Traditional Costing allocates overhead based on a single cost driver, such as machine hours. This method is simple but may not accurately reflect the actual resource consumption of different products.

Job Costing assigns costs to custom products or services. Used when products are distinct and easily identifiable throughout the production process. Costs are traced to each individual job.

Batch Costing - a variant of job costing, where a batch of identical products is treated as a single job.

Process Costing averages costs over all units produced, typically in continuous processes.

ABC Costing - assigns costs to products and services based on the resources they consume. This approach first assigns costs to the activities that are the real cause of the overhead and then assigns the cost of those activities only to the products that are actually demanding the activities.

Target Costing is the process of determining the maximum cost that can be incurred on a product, with the firm still earning the required profit margin from that product when it is sold at the target selling price.

Absorption (Full) Costing Includes all overheads, both variable and fixed, in the cost of products. This ensures comprehensive product costing but can result in higher per-unit costs when production volume is low.

Marginal (Variable) Costing: Only includes variable overheads in product costs, treating fixed overheads as period expenses. This method can provide clearer insights into the impact of production volume on costs, but it may understate the total cost of producing each unit.

4.2 Materials Cost Accounting

Management accountants use several calculations to ensure optimal inventory levels, including reorder levels, maximum and minimum inventory levels, and the cost of holding buffer stock.

Reorder Level

This level is where new stock should be ordered to avoid stockouts. It accounts for the worst-case scenario of maximum usage and longest lead time.

$$\text{Reorder level} = \text{Maximum usage} \times \text{Maximum lead time}$$

Maximum Inventory Level

This is the highest stock quantity that can be stored—accounting for the re-order level, re-order quantity, and minimum usage over the shortest lead time.

$$\begin{aligned} \text{Maximum inventory level} \\ &= \text{Reorder level} + \text{Re-order quantity} \\ &\quad - \text{Minimum lead time} \times \text{Minimum demand} \end{aligned}$$

Minimum Inventory Level (Buffer Stock)

Here, the lowest stock quantity is kept on hand to avoid stockouts, considering the average usage and lead time.

$$\text{Minimum inventory level} = \text{Reorder level} - \text{Average usage} \times \text{Average lead time}$$

Buffer Stock Holding Costs

This includes the cost incurred for keeping the buffer stock on hand, calculated based on the buffer stock quantity and the cost per unit per annum.

$$\begin{aligned} \text{Cost of holding buffer stock} \\ &= \text{Amount of the buffer stock} \times \text{Cost of holding one unit of stock} \end{aligned}$$

These metrics and calculations are essential for effective material cost accounting, ensuring that stock levels are managed efficiently to balance cost and availability.

4.3 Labor Cost Accounting

Cost accounting for labor is critical to management and operational efficiency. Key issues include identifying direct vs indirect costs, managing overtime premiums, and addressing inventory costing and valuation complexities.

Labor cost encompasses all financial compensation, benefits, and taxes a business pays for employee work and is categorized as follows.

- **Direct Labor Costs:** Costs directly associated with the production of goods/services (e.g., wages for assembly line workers)
- **Indirect Labor Costs:** Costs not directly traceable to specific products/services (e.g., salaries for supervisors and maintenance staff)

Employee Payment Systems

Different systems are used to compensate employees based on the nature of work, responsibilities, and business goals.

- **Hourly Wage:** Fixed rate for each hour worked, typical for varying work hours
- **Salary:** Steady payment irrespective of hours, favored in managerial or professional roles
- **Commission:** Compensation tied to sales or deals, motivating sales achievements
- **Piece-Rate:** Pay per produced item, prevalent in manufacturing
- **Bonus Systems:** Extra earnings linked to performance metrics, goals, or firm profitability
- **Profit Sharing:** Yearly share of company profits to employees, fostering alignment with corporate success

Idle Time

Idle time occurs when employees cannot perform productive work due to such factors as equipment failures or material shortages. The following aspects characterize this situation.

- Not linked to specific tasks or products
- Treated as an indirect cost and included in the overhead
- Detrimental to labor efficiency and inflates the cost of goods sold without adding value
- Critical to manage for profitability and operational effectiveness

Measuring Employee Attrition

The Employee Turnover Rate measures how frequently employees depart from the company within a given period, typically annually.

$$\text{Employee turnover rate} = \frac{\text{Number of employees who left during a period}}{\text{Average Number of Employees}} \times 100$$

This ratio aids businesses in the following:

- Assessing employee retention effectiveness
- Pinpointing issues in workplace culture, compensation, or job satisfaction
- Crafting strategies to enhance retention

High turnover rates indicate potential organizational problems, while lower rates suggest good retention.

4.4 Overheads Cost Accounting

Traditional Costing

Traditional costing allocates overhead based on a single cost driver, such as machine hours. This method is simple but may not accurately reflect the actual resource consumption of different products.

Activity-based Costing (ABC)

ABC allocates overhead based on multiple activities that drive costs. This method is more accurate as it considers various activities contributing to overhead costs.

Absorption (Full) Costing

Absorption costing incorporates all overheads (variable and fixed) into product costs, ensuring thorough costing but potentially raising per-unit costs with low production volumes.

Marginal (Variable) Costing

Variable costing includes variable overheads in product costs, treating fixed overheads as period expenses. This method can provide more precise insights into the impact of production volume on costs, but it may understate the total cost of producing each unit.

4.5 Marginal vs Absorption Costing

Marginal Costing

Only variable production costs are included in product costs.

- Direct materials are considered variable costs and are included in the cost of goods sold when incurred.
- Direct labor, like materials, is a variable cost charged to the cost of goods sold when the labor is used in production.
- Only variable overheads are charged to the cost of goods sold. Fixed overheads are treated as period costs and expenses in the incurred period.
- Fixed overheads are treated as period costs and charged to the income statement in the period incurred.

Variable Costing Unit Product Cost

$$= \text{Direct Materials} + \text{Direct Labor} + \text{Variable Overheads}$$

Absorption Costing

All production costs (variable and fixed) are included in product costs.

- Direct materials costs are part of the product cost and are absorbed into the cost of goods sold as inventory is sold.
- Direct labor costs are part of the product cost and are included in the cost of goods sold based on the number of units sold.
- Fixed and variable manufacturing overheads are absorbed into the cost of producing each unit based on a predetermined overhead rate.

- Fixed overheads are allocated to units produced and, therefore, can remain in inventory.

Absorption Costing Unit Product Cost

$$= \text{Direct Materials} + \text{Direct Labor} + \text{Variable Overheads} \\ + \text{Fixed Overhead Allocated per Unit}$$

	MARGINAL COSTING	ABSORPTION COSTING
ADVANTAGES	Provides clarity on the behavior of costs at different levels of production Helps in decision-making, particularly when considering the impact of fixed costs on profit. Prevents overproduction as fixed overheads are not capitalized in inventory.	Recognized by GAAP and IFRS for external reporting. Shows less fluctuation in net income, as fixed overheads are spread over units produced.
DISADVANTAGES	Does not conform to GAAP or IFRS, as it does not include all costs in inventory. May not be suitable for long-term pricing decisions because it excludes fixed costs from product costs.	Can potentially encourage overproduction to absorb fixed overheads. More complex to calculate due to the need to allocate fixed overheads to each unit.
365⁺ JOIN OUR TRAINING FOLLOW US SHARE SAVE		

4.6 Calculating Profits under Marginal and Absorption Costing

Marginal Costing Profit Calculation:

$$\text{Contribution Margin} = \text{Sales Revenue} - \text{Variable Costs}^*$$

*including variable production and variable non-production costs

$$\text{Profit} = \text{Contribution Margin} - \text{Fixed Costs}$$

Absorption Costing Profit Calculation:

$$\text{Gross Profit} = \text{Sales Revenue} - \text{Cost of Goods Sold}^*$$

*including all production costs

$$\text{Profit} = \text{Gross Profit} - \text{Non-production Costs}$$

Marginal Costing Income Statement (ABC Company)				Absorption Costing Income Statement (ABC Company)			
	Units	\$/unit	Total		Units	\$/unit	Total
Sales Revenue	1,775	70	124,250	Sales Revenue	1,775	70	124,250
Less: Production Cost				Less: Full cost of production			
Direct Material Cost	1,805	22	39,710	Direct Material Cost	1,805	22	39,710
Direct Labor Cost	1,805	10	18,050	Direct Labor Cost	1,805	10	18,050
Variable Production Overheads	1,805	6	10,830	Variable Production Overheads	1,805	6	10,830
Contribution Margin			55,660	Fixed Production Overheads	1,775		7,375
Less: Non-Production Cost				Gross Profit			48,285
Variable Non-production Overheads	1,805	12.00	21,660	Less: Admin and selling costs			
Fixed Non-production Overheads			8,000	Variable Non-production Overheads	1,805	12.00	21,660
Fixed Production Overheads			7,500	Fixed Non-production Overheads			8,000
Net Profit			18,500	Net Profit			18,625
				*Fixed production overheads absorbed in inventory/product cost			30
							125

5. Budgeting Basics

5.1 Why Do Companies Need Budgets?

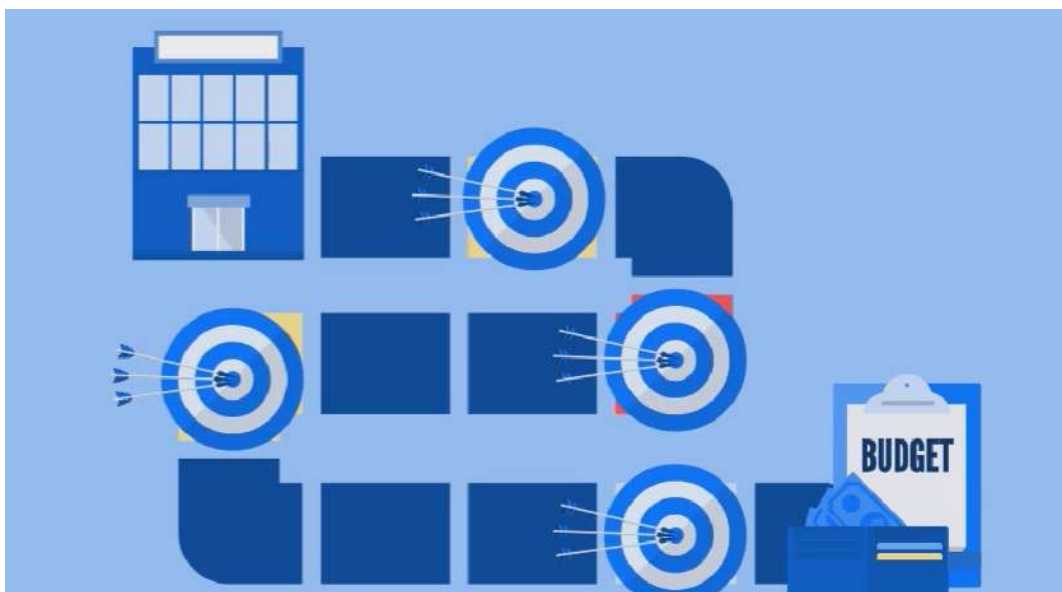
Financial plans (or budgets) are crucial for future forecasting and vital to management control systems. They fulfill the following roles:

- **Planning:** Financial frameworks compel management to strategize for future operations and objectives.
- **Coordination and Communication:** Fiscal tools relay management's expectations throughout the organization.
- **Benchmarking:** Financial guidelines establish a standard against which performance can be compared and assessed.
- **Performance Evaluation:** Fiscal metrics are employed to evaluate the performance of departments and individuals.
- **Resource Allocation:** Allocation plans aid in distributing resources efficiently where they are most needed.
- **Motivation:** Financial outlines can inspire employees to achieve their goals.

5.2 The Importance and Benefits of Budgeting

Budgeting is crucial for any organization as it serves as a comprehensive roadmap for future planning, enabling companies to outline expected revenue, expenses, and resource allocations.

It transforms strategic goals into specific, actionable objectives, ensuring alignment across all departments. By setting ambitious yet realistic targets, budgeting motivates employees and management to achieve their best performance while providing a reality check against actual results.



Benefits of Budgeting

- **Fosters planning and proactivity** - counteracts short-termism and biased perspectives.
- **Target setting tool** - Success is measured by the ability to meet budget targets.
- **Performance management** - Acts as a reality check for assessing performance.
- **Cost control**
- **Revenue maximization** - encourages efforts to surpass revenue expectations.
- **Communication tool** - ensure everyone understands their role in achieving the organization's goals.

Ultimately, budgeting enhances communication, transparency, and accountability, driving overall organizational success.

5.3 Budget Preparation Steps

1. **Set Goals and Objectives:** Define the financial and operational goals of the company for the upcoming period;
2. **Gather Information:** Compile historical data and potential future changes in market conditions;
3. **Initial Preparation:** Draft the initial budget using input from various departments;
4. **Review and Revise:** Discuss the draft with department heads and revise it for a realistic and achievable budget;
5. **Approve:** The final budget is reviewed by senior management and approved;
6. **Communicate:** Once approved, the budget is distributed and used as a guide for operations;
7. **Monitor and Control:** Regularly compare actual results with the budget and investigate variances.



5.4. The Master Budget

The Master Budget is a comprehensive financial planning document that consolidates all individual budgets related to sales, production, operations, and financial activities for a specific fiscal year.

Operating Budgets

Sales Budget

This budget projects future sales revenue based on estimated sales volume and pricing. This is the foundational budget as it drives other operating budgets.

Production Budget

This budget estimates the number of units needed to meet sales goals and desired inventory levels.

- **Direct Materials Budget** estimates the cost of raw materials required for production.
- **Direct Labor Budget** estimates the labor hours and associated costs needed for production.
- The **Manufacturing Overheads Budget** includes all indirect production costs, such as utilities, maintenance, and factory supplies.

Selling, General and Administrative Expenses (SG&A) Budget

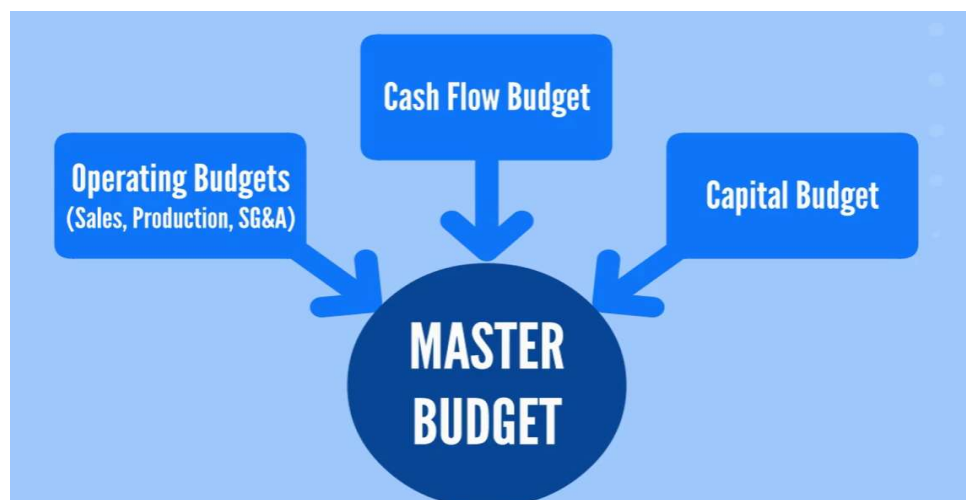
It projects all non-production-related expenses, including salaries, rent, office supplies, and marketing costs.

Cash Flow Budget

This budget is a detailed plan of the organization's cash inflows and outflows over a specific period.

Capital Budget

The capital budget plans for significant investments in long-term assets to support the organization's future operations and growth.



5.5 Budgeting Techniques

Budgeting Approach	Definition	+ Advantages	- Disadvantages
Incremental Budgeting	Uses the previous year's budget as a base, making incremental adjustments (increases or decreases)	+ Simple to implement and understand + Provides continuity and stability + Requires less time and effort	- Can perpetuate inefficiencies - Does not encourage re-evaluation of expenses - Managers may pad budgets
Zero-Based Budgeting (ZBB)	Starts from scratch each period, requiring justification for every revenue and expense item	+ Encourages cost management and efficiency + Ensures resources are allocated based on needs and benefits + Eliminates unnecessary expenditures	- Requires significant time and effort to implement - Can be complex to manage, especially in large organizations
Activity-Based Budgeting (ABB)	Focuses on the costs of activities necessary to produce and sell products and services, aligning budget with cost-driving activities	+ Provides an accurate picture of where resources are needed + Helps manage costs associated with specific activities + Ensures alignment with strategic objectives	- Complex to identify and track all activities and their costs - Requires detailed data collection and analysis
Flexible Budgeting	Adjusts for changes in the volume of activity, separating costs into variable and fixed categories	+ Allows for adjustments based on actual performance + Provides an accurate basis for performance evaluation + Enhances responsiveness to changes in business conditions	- More complex to prepare and manage than static budgets - Requires timely and accurate data on activity levels

365

Incremental Budgeting

Incremental budgeting is a method where the previous year's budget is used as a base, and adjustments are made for the new budget period. These adjustments can be either increases or decreases in amounts.

Advantages

- **Simplicity:** Easy to implement and understand
- **Stability:** Provides continuity and stability from one period to the next
- **Time-Efficient:** Requires less time and effort compared to other budgeting methods

Limitations

- **Inefficiency:** May perpetuate inefficiencies as it assumes existing expenditures are necessary
- **Lack of Innovation:** Does not encourage re-evaluation of existing expenses or consideration of alternative approaches
- **Budgetary Slack:** Managers may pad budgets to ensure increases in future periods.

Example: Imagine a department with a budget of \$100,000 last year. If the management decides to increase the budget by 5% to account for inflation and other factors, the new budget would be \$105,000.

Zero-Based Budgeting (ZBB)

Zero-based budgeting starts from a 'zero base,' and every expense must be justified for each new period. Budgets are built around what is needed for the upcoming period, regardless of whether the budget is higher or lower than the previous one.

Principles

- **Justification of Expenses:** Every expense must be justified and approved.
- **Decision Packages:** Activities are identified in decision packages, which are evaluated and ranked based on importance.

Advantages

- **Efficiency:** Encourages cost management and efficiency
- **Focus on Value:** Allocates resources efficiently based on actual needs and benefits rather than past spending
- **Eliminates Redundancy:** Helps eliminate unnecessary expenditures

Challenges

- **Resource-Intensive:** Requires significant time and effort to implement
- **Complexity:** Can be complex to manage and execute, especially in large organizations

Example: A marketing department needs to justify every expense—such as \$50,000 for a new campaign, \$20,000 for market research, and \$10,000—for promotional events, based on expected outcomes and strategic importance.

Activity-Based Budgeting (ABB)

Activity-based budgeting focuses on the costs of activities necessary to produce and sell products and services. It aligns budgeting with activities that drive costs rather than focusing solely on departmental budgets.

Principles

- **Cost Drivers:** Identifies activities and their cost drivers
- **Resource Allocation:** Allocates resources based on the cost of activities and their contribution to organizational goals

Advantages

- **Accuracy:** Provides a more accurate picture of where resources are needed
- **Cost Management:** Helps in identifying and managing the costs associated with specific activities
- **Strategic Alignment:** Ensures budgets are aligned with strategic objectives

Challenges

- **Complexity:** Can be complex to identify and track all activities and their costs.
- **Data-Intensive:** Requires detailed data collection and analysis.

Example: A company allocates its budget based on activities—such as production (\$500,000), quality control (\$100,000), and distribution (\$150,000)—rather than simply allocating a lump sum to departments.

Flexible Budgeting

A flexible budget adjusts or flexes for changes in the volume of activity. It's more sophisticated than a static budget and provides a more accurate reflection of costs. Unlike a static budget—which remains at one amount regardless of the activity level—a flexible budget scales according to revenue or activity levels.

It's most useful for businesses where costs are heavily influenced by changes in sales volume or other activity measures.

Principles

- **Variable and Fixed Costs:** Separate costs into variable and fixed categories
- **Adjustments:** Adjust budgeted costs based on actual activity levels

Advantages

- **Real-Time Adjustments:** Allows for adjustments based on actual performance
- **Performance Evaluation:** Provides a more accurate basis for performance evaluation
- **Responsiveness:** Enhances responsiveness to changes in business conditions

Challenges

- **Complexity:** More complex to prepare and manage than static budgets
- **Data Requirements:** Requires timely and accurate data on activity levels

Example: A manufacturing company prepares a flexible budget based on different levels of production volume. If the production is 10,000 units, the budget adjusts variable costs like raw materials and labor to reflect this level rather than sticking to the budget prepared for an estimated 8,000 units.

5.6 Budgeting vs Forecasting

ASPECT	BUDGET	FORECAST
Definition	Strategic plan for financial performance	Projection based on the latest financial data and trends
Main purpose	Setting targets for a specified period	Estimating whether overall performance achieves targets
Timeframe	Long-term projections (one year or longer)	Short-term projections
Flexibility	Rarely adjusted, static document	Frequently updated

5.7 Budgeting Control and Variance Analysis

Budgetary control is the process of monitoring and controlling the budgets to ensure that the organization's financial goals are met. It involves comparing actual performance with budgeted figures and taking corrective actions when necessary.

Establishing budget centers, assigning responsibility, and setting up a system for monitoring and reporting are key components of budgetary control.

Variance Analysis

Variance analysis is the process of comparing actual financial performance with budgeted figures to identify differences, known as variances. This analysis helps understand why variances occur and what actions can be taken to correct them.

Variances can be **favorable** or **adverse**. A favorable variance means actual income exceeds budgeted projections or expenses fall below them. Conversely, an adverse variance arises when income falls short of the budget or costs exceed it.



To perform variance analysis, take the following **steps**:

- 1. Calculate Variances:** Determine the difference between actual and budgeted figures for each income and expense category;
- 2. Analyze Causes:** Explore the causes of the discrepancies, considering external influences like market conditions and internal issues like inefficiencies or errors;
- 3. Take Corrective Action:** Based on the analysis, take appropriate actions to address unfavorable variances and reinforce favorable ones. This may include revising budgets, improving processes, or reallocating resources;
- 4. Report Findings:** Communicate the variance analysis results to relevant stakeholders. This will ensure that everyone is aware of the financial performance and any necessary actions.

Variance analysis is essential for several reasons.

- **Performance Evaluation:** It helps evaluate the financial performance of different departments and the organization.
- **Cost Control:** Organizations can control costs and improve efficiency by identifying and addressing unfavorable variances.
- **Decision Making:** Variance analysis provides valuable insights that aid in making informed financial decisions.
- **Accountability:** It promotes accountability by assigning responsibility for budgetary performance to managers and departments.
- **Strategic Planning:** Variance analysis helps assess whether the organization is on track to meet its strategic goals and objectives.

6. Standard Costing and Variance Analysis

6.1 Understanding Standard Costs

Standard costs are the expected labor, material, and overhead costs associated with a product or service. They're predetermined unit costs that companies use to compare the actual costs incurred. They provide a basis for budgeting, cost control, and performance evaluation.

Development

Standard costs are developed using historical data, industry benchmarks, and analysis of current market conditions.

6.2 Standard Costing Benefits and Limitations

Benefits

- Provides a clear target for cost control and efficiency improvements
- Simplifies the budgeting process
- Enhances decision-making
- Facilitates performance evaluation

Limitations

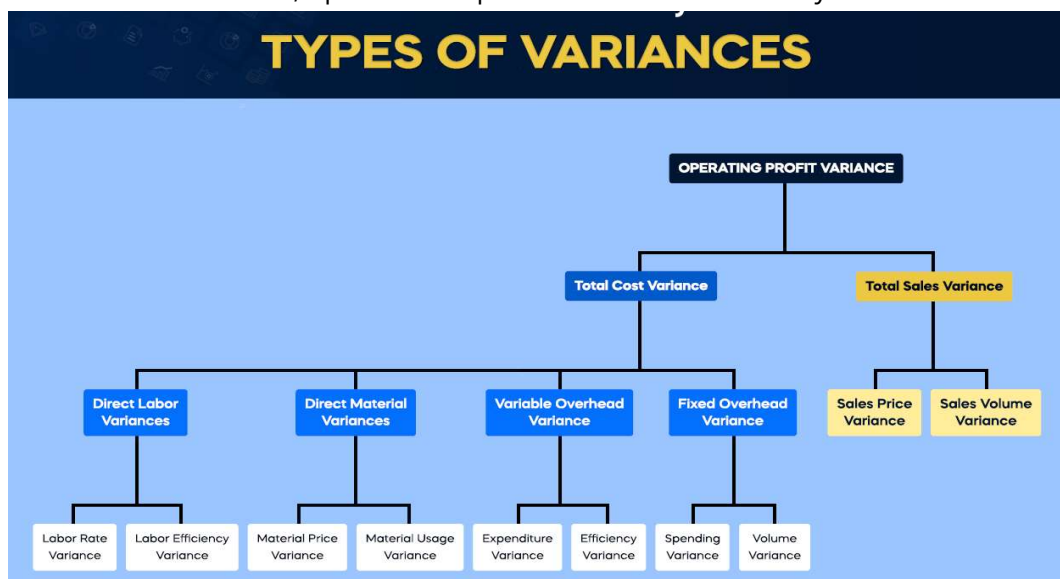
- May lack the flexibility needed to adjust to evolving market conditions or business processes
- Could promote undesirable actions like bulk buying to gain favorable price variances, risking surplus inventory
- Might become obsolete without frequent reviews and updates
- Potentially unsuitable for businesses with unique operations or those implementing lean manufacturing
- Focusing only on variances may neglect broader strategic objectives.



6.3 Variance Analysis Overview

Variance analysis calculates and assesses the discrepancies between planned and actual financial performance.

- **Total Sales Variance** measures the gap between expected and actual sales revenue, broken down into price and volume variances.
- **Total Cost Variance** captures the divergence between projected and actual costs, including variances in materials, labor, and overhead.
- **Material Variance** assesses the difference in expected versus actual material costs—further split into price and usage variances.
- **Labor Variance** evaluates the gap between anticipated and actual labor costs, divided into rate and efficiency variances.
- **Variable Overheads Variance** gauges the discrepancy between budgeted and actual overhead costs, split into expenditure and efficiency variances.



6.4 Sales Variances

Total Sales Variance

$$\begin{aligned} &= \text{Actual Sales Quantity} \times \text{Actual Selling Price} \\ &\quad - \text{Standard Sales Quantity} \times \text{Standard Selling Price} \end{aligned}$$

Sales Volume Variance is the difference between the actual quantity sold and the standard quantity multiplied by the standard selling price.

Sales Volume Variance

$$\begin{aligned} &= (\text{Actual Sales Quantity} \\ &\quad - \text{Standard Sales Quantity}) \times \text{Standard Selling Price} \end{aligned}$$

Sales Price Variance is the difference between the actual and standard selling prices multiplied by the actual sales quantity.

Sales Price Variance

$$= (\text{Actual Selling Price} - \text{Standard Selling Price}) \times \text{Actual Sales Quantity}$$

6.5 Material Variances

Total Material Variance

$$= \text{Standard Quantity} \times \text{Standard Price} - \text{Actual Quantity} \times \text{Actual Price}$$

Material Price Variance is the difference between the standard and actual price paid for materials multiplied by the quantity purchased.

$$\text{Material Price Variance} = (\text{Standard Price} - \text{Actual Price}) \times \text{Actual Quantity}$$

Material Usage Variance is the difference between the standard quantity expected for production and the actual quantity used multiplied by the standard price.

$$\text{Material Usage Variance} = (\text{Standard Quantity} - \text{Actual Quantity}) \times \text{Standard Price}$$

6.6 Labor Variances

$$\text{Total Labor Variance} = \text{Standard Hours} \times \text{Standard Rate} - \text{Actual Hours} \times \text{Actual Rate}$$

Labor Rate Variance is the difference between the standard hourly labor rate and the actual rate multiplied by the hours worked.

$$\text{Labor Rate Variance} = (\text{Standard Rate} - \text{Actual Rate}) \times \text{Actual Hours}$$

Labor Efficiency Variance is the difference between the standard hours expected for production and the actual hours worked multiplied by the standard labor rate.

$$\text{Labor Efficiency Variance} = (\text{Standard Hours} - \text{Actual Hours}) \times \text{Standard Rate}$$

6.7 Total Variable Overhead Variances

Total Variance Overhead Variance

$$= \text{Standard Hours} \times \text{Standard Rate} - \text{Actual Hours} \times \text{Actual Rate}$$

Variable Overhead Variances include variable overhead efficiency variance and variable overhead expenditure variance.

Variable Overhead Expenditure Variance

$$= (\text{Standard Variable Overhead Rate} \\ - \text{Actual Variable Overhead Rate}) \times \text{Actual Hours}$$

Variable Overhead Efficiency Variance

$$= (\text{Standard Hours} - \text{Actual Hours}) \times \text{Standard Variable Overhead Rate}$$

6.8 Reconciliation between Standard and Actual Profit

This process adjusts the budgeted profit to reflect actual conditions encountered during the period by analyzing variances that explain differences between expected and actual results.

7. Performance Measurement & Control

7.1 Performance Measurement - Overview

Performance measurement involves statistical evidence to determine progress toward specific defined organizational objectives.

Purpose

It includes a wide range of activities to assess the efficiency and effectiveness of actions.

Components

The components include key performance indicators (KPIs), financial metrics, operational metrics, and benchmarks.

Application

Performance measurement tools and techniques are used to:

- Evaluate employee performance
- Assess organizational efficiency
- Align strategies with business objectives
- Drives strategies for continuous improvement

7.2 Key Performance Indicators (KPIs)

KPIs are quantifiable measures that gauge a company's performance against its strategic and operational goals.

Characteristics

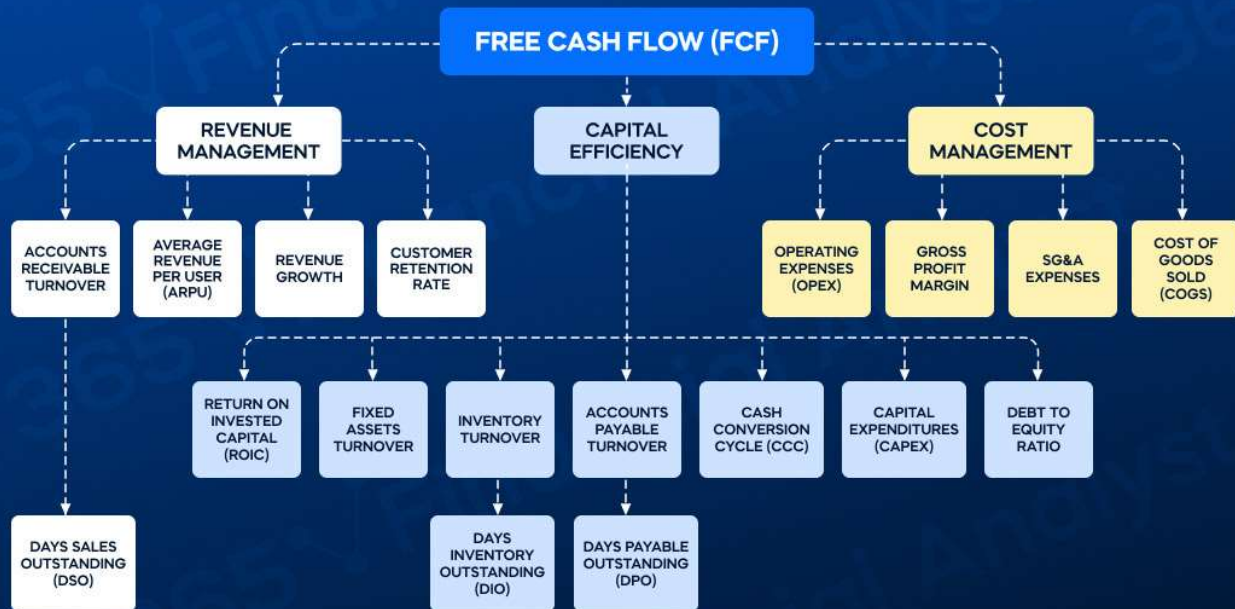
- Relevant: Directly linked to organizational goals
- Actionable: Indicate areas needing action
- Measurable: Provide a quantitative basis for decision-making

Examples: Revenue growth, profit margin, customer satisfaction, and employee turnover rates





Cash Flow KPIs



REVENUE MANAGEMENT

REVENUE GROWTH

Increases sales revenue, enhancing cash inflow.

ACCOUNTS RECEIVABLE TURNOVER

Measures how quickly receivables are collected, improving cash flow.

DAYS SALES OUTSTANDING (DSO)

Lower DSO means faster collection of receivables, improving cash flow.

CUSTOMER RETENTION RATE

Higher retention rate means more recurring revenue, improving cash flow.

AVERAGE REVENUE PER USER (ARPU)

Higher ARPU increases overall revenue, enhancing cash inflow.



CAPITAL EFFICIENCY

INVENTORY TURNOVER

Faster turnover reduces cash tied up in inventory.

DAYS INVENTORY OUTSTANDING (DIO)

Lower DIO indicates quicker conversion of inventory to sales, enhancing cash flow.

ACCOUNTS PAYABLE TURNOVER

Efficient payables management retains cash longer.

DAYS PAYABLE OUTSTANDING (DPO)

Higher DPO means delayed payments to suppliers, conserving cash.

CASH CONVERSION CYCLE (CCC)

Shorter CCC means quicker conversion of investments to cash.

CAPITAL EXPENDITURES (CAPEX)

High CapEx can strain cash flow in the short term but may drive long-term growth.

DEBT TO EQUITY RATIO

Lower ratio indicates less reliance on debt, reducing interest payments and improving FCF.

RETURN ON INVESTED CAPITAL (ROIC)

Higher ROIC indicates better efficiency in generating returns from capital, enhancing FCF.

FIXED ASSET TURNOVER:

Higher turnover means better utilization of fixed assets, improving cash flow.



COST MANAGEMENT

GROSS PROFIT MARGIN

Higher margins indicate better profitability, contributing to higher cash flows.

OPERATING EXPENSES (OPEX)

Lower operating expenses reduce cash outflows, improving FCF.

COST OF GOODS SOLD (COGS)

Lower COGS increases gross profit margin, improving cash flow.

SG&A EXPENSES

Lower Selling, General, and Administrative expenses reduce cash outflows, improving FCF.



JOIN OUR TRAINING



FOLLOW US ON LINKEDIN



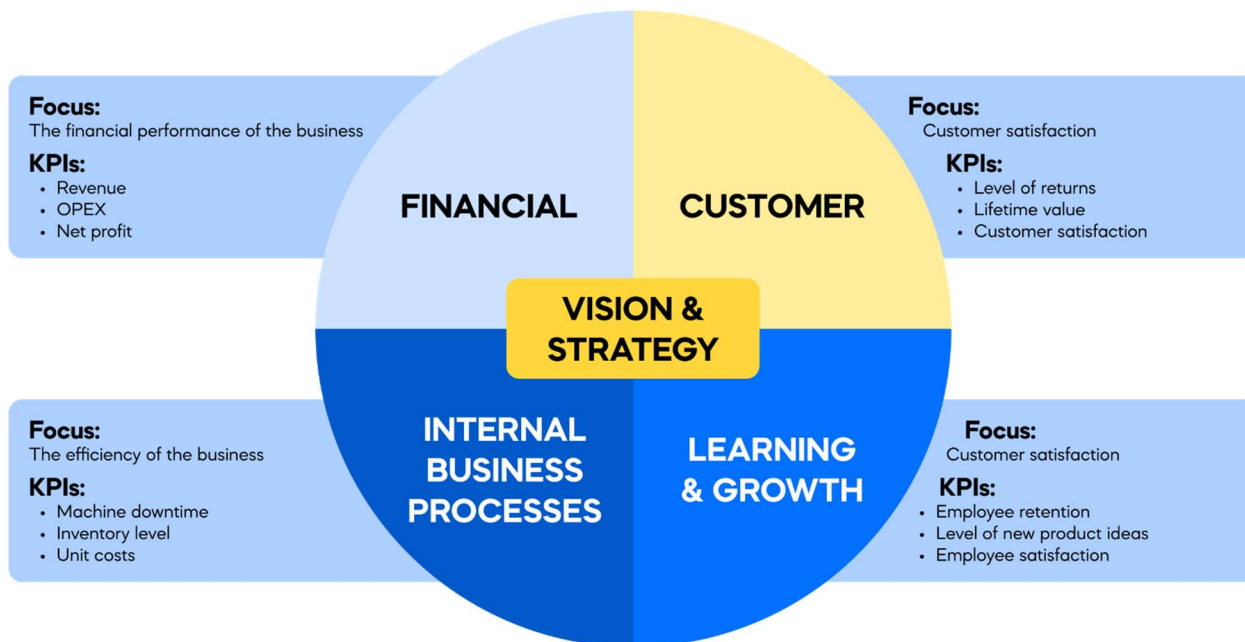
SHARE THIS POST

7.3 Balanced Scorecard

The **Balanced Scorecard** is a strategic planning and management system used for business and industry, government, and nonprofit organizations worldwide to align business activities to the vision and strategy of the organization.

It converts vision and strategy into operational objectives that drive behavior and performance in four major perspectives:

- **Financial:** Profitability, growth, shareholder values
- **Customer:** Customer satisfaction and retention
- **Internal Business Processes:** Efficiency, output, quality
- **Learning and Growth:** Employee development and innovation



7.4 Performance Control Systems

Internal Controls include systems and procedures implemented to ensure the integrity of financial and accounting information, promote accountability, and prevent fraud.

Risk Management involves forecasting and evaluating financial risks and identifying procedures to avoid or minimize their impact.

Monitoring includes regularly tracking performance against KPIs and objectives to ensure that strategic goals are met.

Reporting concerns communicating performance measurement to stakeholders through reports that may include financial statements, management's discussion and analysis, and explanatory notes.

7.5 Benchmarking

Benchmarking is the process of comparing an organization's performance metrics to industry bests or best practices from other industries.

Purpose: To identify areas of improvement, set performance goals, and enhance overall efficiency and effectiveness.

Types of Benchmarking

1. Internal Benchmarking

- Comparing performance metrics within the same organization across different departments or units.
- Useful for large organizations with diverse operations.

2. Competitive Benchmarking

- Comparing an organization's performance with direct competitors.
- Focuses on industry-specific standards and practices.

3. Functional Benchmarking

- Comparing similar functions or processes across different industries.
- Identifies best practices that can be adapted to the organization.

4. Generic Benchmarking

- Comparing broad-based processes or functions regardless of industry.
- Focuses on innovative practices that can improve performance.



GLOSSARY

Activity-Based Budgeting (ABB): A budgeting method that focuses on the costs of activities necessary to produce and sell products and services. It allocates resources based on the cost of activities and their contribution to organizational goals.

Activity-Based Costing (ABC): A costing methodology that identifies activities in an organization and assigns the cost of each activity to all products and services according to the actual consumption.

Balanced Scorecard: A strategic planning and management system used to align business activities to the vision and strategy of the organization.

Benchmarking: A process by which a company evaluates various aspects of their operations in terms of best practices within their sector or industry.

Break-Even Point: The volume of production or sales at which total revenues equal total costs.

Budget: A financial plan for a defined period; an estimate of income and expenditure for a set time.

Buffer Stock: Inventory held in reserve to protect against unforeseen shortages or demands. Calculated as the reorder level minus average usage multiplied by average lead time.

Capital Budget: A detailed plan for the acquisition of long-term assets and investments to support future operations and growth.

Contribution Margin: Sales revenue minus variable costs.

Contribution Margin Ratio: The ratio of the contribution margin to total sales revenue. It indicates the percentage of each sales dollar that contributes to covering fixed costs and generating profit.

Cost: The monetary value spent to produce goods or services.

Cost Drivers: The structural determinants of the cost of an activity, reflecting any linkages or interrelationships that affect it.

Cost of Holding Buffer Stock: The expense incurred for maintaining buffer stock, calculated as the amount of buffer stock multiplied by the cost per unit per annum.

Cost-Benefit Analysis: A systematic approach to estimating the strengths and weaknesses of alternatives used to determine options that provide the best approach to achieving benefits while preserving savings.

Cost-Volume-Profit (CVP) Analysis: A method of cost accounting used in managerial economics to determine the breakeven point of cost and volume of goods.

Direct Costs: Costs that can be directly attributed to the production of specific goods or services.

Employee Turnover Rate: The rate at which employees leave a company within a given period, typically calculated as the number of employees who left divided by the average number of employees, multiplied by 100.

Financial Accounting: The field of accounting concerned with the summary, analysis, and reporting of financial transactions related to a business.

Fixed Costs: Business costs, such as rent, that are constant whatever the quantity of goods or services produced; they do not vary with the volume of production.

Flexible Budget: A budget that adjusts or flexes for changes in the volume of activity. It is more accurate than a static budget and scales according to revenue or activity levels.

Idle Time: The time during which employees are paid but are not productive, often due to equipment failure or material shortages. Treated as an indirect cost and included in overhead.

Incremental Budgeting: A budgeting method where the previous year's budget is used as a base and adjustments are made for the new budget period.

Indirect Costs: Costs that are not directly traceable to a cost object such as a particular project, but are related to the business's overall operating expenses.

Internal Control: A process for assuring the achievement of an organization's objectives in operational effectiveness and efficiency, reliable financial reporting, and compliance with laws, regulations, and policies.

Job Costing: The accounting method used to track the expenses of a specific job such as materials, labor, and overheads.

Key Performance Indicators (KPIs): Quantifiable measures that gauge a company's performance against its strategic and operational goals.

Management Accounting: The process of identifying, measuring, analyzing, interpreting, and communicating information for the pursuit of an organization's goals.

Margin of Safety: The amount by which sales can drop before reaching the break-even point. Calculated as current sales minus break-even sales.

Master Budget: A comprehensive financial planning document that consolidates all individual budgets related to sales, production, operations, and financial activities for a specific fiscal year.

Opportunity Cost: The benefit that is missed or given up when choosing one alternative over another.

Process Costing: A cost allocation method that traces and accumulates direct costs, and allocates indirect costs of a manufacturing process.

Reorder Level: The stock level at which new orders should be placed to avoid stockouts. Calculated as maximum usage multiplied by maximum lead time.

Return on Investment (ROI): A performance measure used to evaluate the efficiency or profitability of an investment.

Standard Cost: The expected cost of labor, materials, and overhead for a product or service, used for budgeting, cost control, and performance evaluation.

Standard Costing: A cost allocation method that estimates the expected costs of production.

Stepped Costs: Remain fixed over a range of activity but change (step up or down) once that range is exceeded, such as the cost of additional machinery or personnel when production capacity is increased.

Variable Costs: Costs that vary directly with the production volume or level of activity.

Variance: The difference between a budgeted, planned, or standard cost and the actual amount incurred/sold.

Variance Analysis: A quantitative investigation of the difference between actual and planned behavior.

Zero-Based Budgeting (ZBB): A budgeting method that starts from a zero base, and every expense must be justified for each new period.

Master the Finance Skills Necessary to Succeed. Now at **60% OFF!**

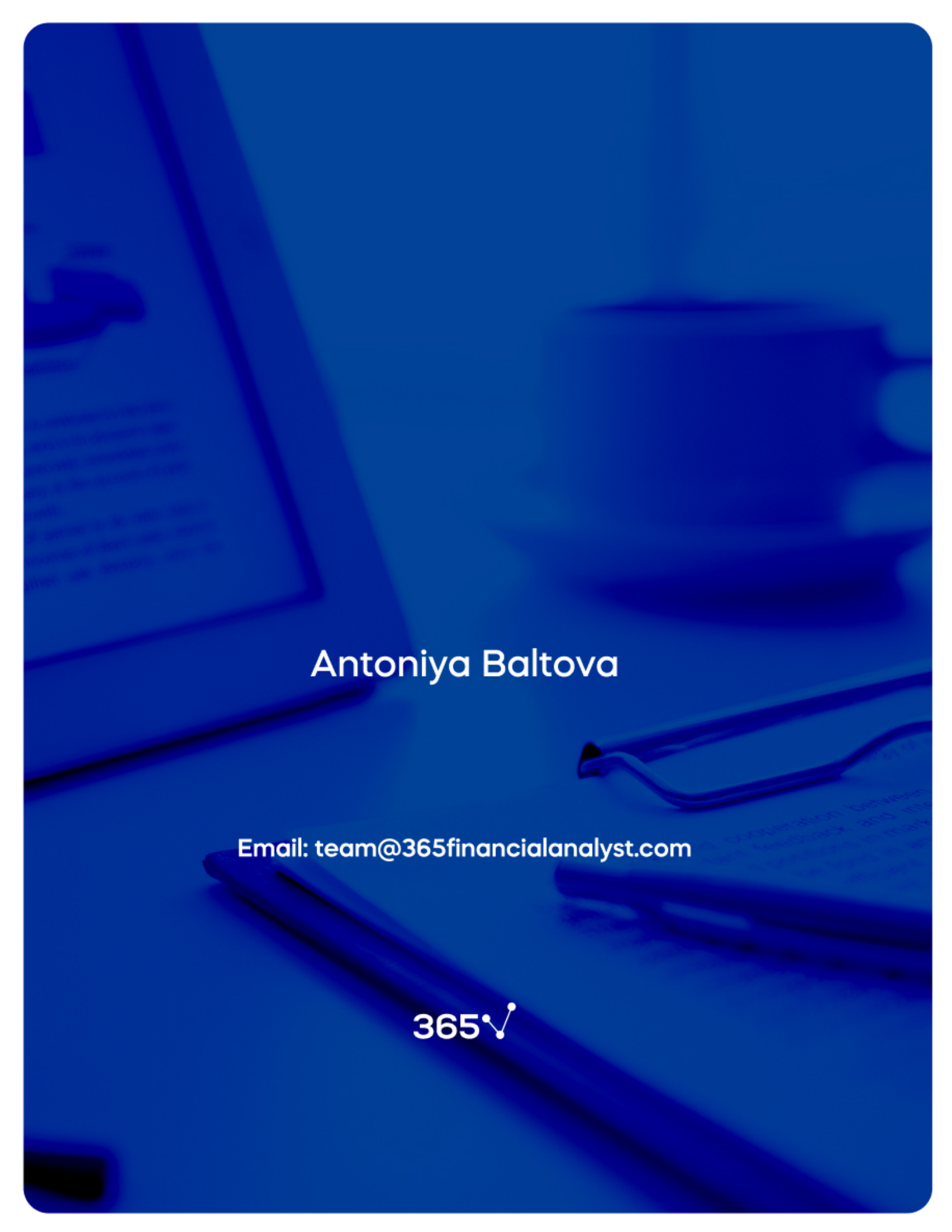
Become an expert in financial reporting, accounting, analysis, or modeling with our **comprehensive training program.**

- ★ Learn from industry-leading instructors and gain practical skills to advance your career.
- 🕒 Build your knowledge with self-paced courses and enjoy the flexibility of online learning.
- 🏆 Validate your skills with exams and certificates demonstrating your expertise to potential employers.
- 📄 Stand out in the job market with a strong resume created with our resume builder.

Save 60% on an annual plan from the online learning program that helped more than **2 million people** advance their careers.

Start learning now

30-day money-back guarantee



Antoniya Baltova

Email: team@365financialanalyst.com

365 