

# [The purpose of cash budgets](https://assignbuster.com/the-purpose-of-cash-budgets/)

Cash budget is an inflow and outflow of cash estimate prepared by management in a business for a specific period of time. It helps management in credit control and determines whether there is available fund for extending operations. The purpose of undertaking this report is to forecast a cash flow for the six months ending 30th June 2011, setting up healthy credit control system, and identifying the factors to be considered when planning to invest any forecasted surplus cash for Enron limited which currently faced financial difficulties in certain months of the year ending 31st December 2010.

THE CASH BUDGET

Cash budget is an estimation of a company’s cash inflow and outflow, it is an accounting device used in monitoring and managing a business’ operating activities of immediate short term cash flow, a forecast of a business’s estimated cash receipts and payment over a period of time usually months and years. All budgets are related to the cash budget which is a forecast of the cash receipts and payments for the period, the importance of preparing a cash forecast cannot be over stressed for the availability of adequate cash resources is vital to successful business operation. Workers must be paid in cash, taxation liabilities must be settled in cash, suppliers may withhold materials unless paid promptly and so on. In most cases a monthly cash budget will be found adequate as settlements between debtors and creditors are conventionally made at the end of each calendar month (Joseph Baggott, 1973).

PURPOSE OF CASH BUDGET

In recent financial world, it is required by most business organisation to prepare cash budget prior to making expenditure related to any planned development or acquaintance of new assets. The cash budget determines firm’s ability settling its liabilities and expenses. secondly it helps in evading possible cash shortages and idle cash, thirdly it assist management in making decision in regards to its cash reserve for furthering its activities, fourthly it assist the management in achieving the objectives of the business in a specific period of time and lastly it enables the actual financial operation to be measured against the forecast of the business.

LITERATURE REVIEW

According to Garrison, Noreen and brewer 2006, most companies encounter problems when preparing their budget due to an increase in inflation rate, exchange rates of foreign currency, governmental policies and the economy situation while McCain 1999 states that most budgets are only provided for finances not the people and that finance alone is not enough in achieving improvements of company performance. Budget provides immediate control over the environment assists to master the financial phase of job and department and helps decipher problems prior to their occurrence (Ali Osman Gurbus, 2010).

In light of the differences highlighted above, the company should try to provide room for any future inconveniences, human resource management and estimate future receipts and expenditure so as to be able to tackle problems before their occurrence.

BUDGET COMMITTEE

The budget committee consists of high level executives in charge of various functions (i. e. sales, production and purchasing). In financial procedure the functional head obtain an approval by presenting their budget to the committee, if the level of budget doesn’t contain a reasonable performance, the functional head will required further changes in order to obtain an approval. The budget committee appoints a budget officer known as the accountant, whose take actions and coordinates the individual budgets of a company. (Colin Drury, 2000) The figure 1 chart below indicate the organization chart of a budget committee

Figure 1

MASTER BUDGET

This budget can be analyzed into operational budget and financial budget, it culminates and are summarized in a company’s budgeted cash flow statement, budgeted profit and loss account and budgeted balance sheet statement of a business, it show the financial performance of a company and helps the manager to plan and achieve further for the future. The budgets are approved by the authority manager of a responsibility centre to carry out plans and then passed down through the company to the appropriate centres. (Willie Seal, Ray H. Garrison, Eric W. Noreen, 2006). Figure 2 below indicates the major parts of a master budget including the operating and the financial budget.

Figure 2

PURPOSE OF MASTER BUDGET

The master budget is used to integrate and coordinate the functional areas within a company’s operating activities, provide a method of evaluating and controlling subsequently aspects of budget, and it serve as a communicative device in which the staff contribute effort to the overall goals within an organization process being inform of policies and plans, also helps motivates its employees to perform in line with the objectives. Master budget helps promote continuous performance of the company’s business in planning process to supports the management to consider choices that reduce costs and improve value of customer.

STAGES IN THE BUDGETING PROCESS

The budget created and approved by the management move through set of procedure. In preparation of a budgeting process, the procedures in creating the budget differs from one organization to another and should be presented to the budget committee before it is finally agreed. Some important stages in the budgeting process are as follows:

I. Communicating details of budget policy and guidelines : A long term planning process is the starting point in the preparation of a company’s annual budget, the manager are responsible for preparing and communication of budget policy affected by the long term plans and provide important guidelines to the top manager to meet their objective.

II. Determining the factors that restrict output: Company performance is restricted through limiting factors such as raw materials, labour and machine hour. The principal machine capacity of production restricts performance when the sales demand excess the available capacity and can be determined by the top management.

III. Preparation of the sales budget: In many organizations the sale volumes and mix determine the level of operations that restricts a company’s output, a sale forecast of a business has to be created before the sale budget can be prepared.

IV. Initial preparation of budgets: The budgets are originated by the lower level of management and are coordinated by the higher level of management. The managers are responsible and participates in the preparation of meeting the performance of a company’s budget and providing the top management for determining the content of budgets

V. Negotiation of budgets: Once a budget has been prepared by the manager, it should be submitted to the superior to obtain an approval and acceptance. The budget should be agreed and negotiated by parties, the manager and the superior. This process is essential in the budgeting process as it determines whether or not a company’s budget has effective tools of management.

VI. Coordination of budgets: The budget is likely to be reviewed belonging to another which indicate and modify if the budget are out of balance, the chief accountant identify such disagreement and inform them to the manager’s attention and modifying such changes that should be made. During this revision process the manager ensure the budgeted profit and loss account, budgeted balance sheet statement and the cash budget are prepared to prove acceptance.

VII. Final acceptance of the budget: After all the budgeted profit and loss account, budgeted balance sheet statement and the cash budget have been accepted , they are then summarized into the master budget to approve and then passed down through the company to the suitable responsibility centres.

VIII. Budget review : The budgeting process does not stop until it have been agreed and on a regular basis there should be a comparison between the actual results and the budgeted results, which should be sent to the management for investigation of possible differences in reason. If the reasons of differences are within the areas of control of management, corrective measure should be taken and to ensure such inefficiencies not to occur in the future.

FACTORS TO CONSIDER IN INVESTING FORECASTED CASH SURPLUS BUDGET

In Appendix 1 Enron Ltd cash budget indicates that sales are lower in January till March and increased in April upward to June. The cash surplus occurs in January, February and March which it is the excess of cash receipts over payment, but the cash deficits occurs from April to June which indicate available funds cash payments exceed the cash receipts. Therefore an investment in cash surplus can be on a short term basis in risk free securities and bank deposits which can easily be transformed into cash to settle off debts. Such investment chosen are relied on involved risk, size of existing amount, offered yield and consequences for early withdrawal. Since the company has been having financial difficulties in the previous year ending 31st December 2010 for a period of short time, it might be obscurity in obtaining long term sources of investment

CREDIT CONTROL SYSTEM

Management of cash flow is an essential part of accounting procedure in business in which management should take notice of when planning budget. Good credit control system must be set by an organization in order to ensure prompt payment from customers so as to be able to meet short term obligations and avoid the risk of being bankrupt. The following are the steps in which firms should undertake in order to achieve an effective credit control system.

I. Set up a detailed credit control system: It allows company to identify the invoices that has been raised, paid and sent to customers. Each individual customer have a separate file with details indicating their contact name, business name and address, contact number and postal address.

II. Credit check customers: Enron limited should approach customer’s bank or counterpart suppliers for reference to check on potential debtor credit worthiness before trading.

III. Decide on payment terms: Enron limited should clearly display their payment terms on their invoice and ensure that customers are aware company credit policy.

IV. Post invoices promptly: The Firm should send out invoices to respective customer on same date goods dispatched and make sure it is delivered to the right person and address.

V. Deciding on reminder procedure: The Company should flag all their invoices that are due and send customers statement of account to each customer through e-mail or post to serve as reminders. Telephone calls should also be used to chase payments.

VI. Make a Stop list for late-paying debtors: This is a list which the firm should prepare and send to appropriate employee in order to stop goods being supplied to owing customers. Debtors should also be aware of the list.

VII. Organizing a sufficient overdraft: The Company should have available funds to cover their cash flows and consider paying up percentage of invoices in return for commission

ADVANTAGES AND DISADVANTAGES OF USING OVERDRAFT FINANCE

As it is clearly stated above, Enron Limited experienced cash shortfall in certain months of the year from its past operations indicating that it needs to outsource income in order to continue its operation. Bank overdraft is one of the method in which a company use to overcome its deficits in terms of any cash shortage arousal. An overdrawn is said to be when the company withdraws more than what it has in its bank account. It has some advantages and disadvantages . The main advantages of using bank overdraft is its flexibility in financing daily business activities and interest are only be paid on the overdrawn amount while its disadvantages are, interest rates are higher than loans and bank can request for repayment from company at any point in time leaving the company with no contingency funds if regularly overdrawn.

LIMITATION OF CASH BUDGET

Cash budget if appropriately prepared and implemented is very helpful to the business, but there are number of limitation associated to it that must be taken into account. First and foremost is uncertainty, budgeting involves extensive amount of forecasting the future which is not easy to have near correct estimate of company’s cash receipts and expenditure, it might lead to undesirable condition e. g. losing customers in terms strict payment policy if there is no flexibility in applying the cash budget by the finance manager. Also employees who do not agree in some part of the budget will feel not liable for any inconveniences which may arise in the future, and last but not the least is expensive as it require substantial amount of money, time and effort.

INTERPRETATION AND RECOMMENDATION

In light of the study performed above Enron Limited had cash surpluses from January to March while experienced cash shortages from April to June (Appendix 1). All sales made by the company are on credit and payments are received in the second month following the month of sale.

The financial consultants recommend Enron limited to introduce cash discount sales in order to encourage cash sale and set a good credit control system in order to have prompt payment from debtors and avoid the risk of bad debt. Cash budget should be prepared by the company in order to anticipate future receipts and payments but flexibility should be attached to it where necessary in order to avoid losing customers. Enron limited cash surpluses should be invested in short term basis in order to regain cash easily when needed while its cash deficit should be conquered by bank overdraft in so as to be able to continue its operation as interest rate is only charged on the overdrawn amount.