BANGLADESH
COST ACCOUNTING
STANDARDS

BCAS - 19

Budget and Pro Forma Financial Statements

BCAS 19: Budget and Pro Forma Financial Statements

19.1 Introduction

Budget is a very important management accounting tool used in organizations to plan and control future courses of action. It should be wisely drawn so that it can ensure more discipline in spending and collection of resources leading towards the achievement of corporate ultimate goal. Organizations may have its own philosophy and pattern of formulating and implementing budget. This standard presents budget mechanism covering every aspect of budget process which can be a broad guideline for any company irrespective of its typical structure. The standard also covers the end result of budget in the form of pro forma financial statements.

19.2 Objectives

Budgets are used primarily for two purposes. First, planners use budgets to project or estimate the financial consequences of alternative strategic plans in the process of choosing among those plans. Second, budgets are used to project operating and cash flow results in order to anticipate capacity, resource, or financing requirements. Keeping these in mind, the purpose of this standard is twofold:

a. It considers the nature and scope of budgeting and
b. It prescribes the format of pro forma financial statements along with its relationship with budget.

19.3 Scope

19.3.1 This standard shall be applied in planning, formulating, and implementing budget in an organizational setup.

19.3.2 More specifically, the standard shall be applied in cost and management accounting practices relating -

a) To select budget philosophy;
b) To formulate different budget estimates;
c) To implement budget;
d) To follow up budget; and
e) To prepare and use pro forma financial statements.

19.3.3 This standard may be followed by companies and other business or non-business organizations where cost and management accounting is in practice either as a statutory obligation or to support management decision making process.

19.4 Key Features

The key features of this standard are pointed below -

a) Presenting the budget implementation process;
b) Identifying critical factors in successful implementation of budget;
c) Administering administrative issues in budgeting process;
d) Showing the relationships in master budget system; and
e) Exploring the importance of pro forma financial statements.

19.5 Definitions:

The following terms are used in the standard with the meanings specified:

19.5.1 **Budget:** A budget is a quantitative expression of a plan for a defined period of time which includes among other things planned sales volumes and revenues, resource quantities, costs and expenses, assets, liabilities and cash flows expressing strategic plans of business units, organizations, activities or events in measurable terms.

19.5.2 **Budget Period:** The budget period is the specific future period of time with reference to which budget is prepared which is usually one year.

19.5.3 **Budget Committee:** Budget Committee consists of a group of people usually from top management who creates and maintains fiscal responsibility for an entity or organization and typically reviews and approves departmental budgets that are submitted by the various department heads.

19.5.4 **Pro forma Financial Statements:** Pro forma financial statements are the complete set of financial reports issued by an entity incorporating assumptions or hypothetical conditions about events that may have occurred in the past or which may occur in the future which is usually used to present a view of corporate results to insiders to run the operation smoothly as per plan and to outsiders as part of an investment or lending proposal.

19.5.5 **Zero Based Budgeting:** Zero-based budgeting (ZBB) is a method of budgeting in which all expenses must be justified for each new period having a "zero base" and every function within an organization is analyzed for its needs and costs. Budgets are then built around what is needed for the upcoming period, regardless of whether the budget is higher or lower than the previous one.

19.5.6 **Budgetary Control:** Budgetary Control is the process of establishment of budgets relating to various activities and comparing the budgeted figures with the actual performance for arriving at deviations, if any. It is a system which uses budgets as a means of planning and controlling.

19.5.7 **Participative Budgeting:** Participative budgeting is a bottom-up approach in budgeting process under which those people impacted by a budget are actively involved in the budget creation process.

19.5.8 **Autocratic Budgeting:** Autocratic budgeting follows a top-down approach where some targets in the form of budget is forced on subordinate managers from the top.

19.5.9 **Budget Manual:** It provides a set of guidelines as to who is involved with the budgetary planning and control process and how the process is to be conducted.

19.6 Standards

19.6.1 **Budget may be prepared in either autocratic or participative way considering the policy of the respective budget setting unit. Each of these philosophies has its own merits and demerits. This standard doesn't provide any choice rather it is left at the discretion of the management.**

19.6.2 Informal observation of practice and systematic research unequivocally suggest that, when budgets are used for planning and control purposes, participative budgets are more effective in securing target results than autocratic budgets.

19.6.3 **Budget should be prepared with reference to a budget period which should not be more than one year. However, it may be prepared for any smaller periods (i.e., weekly, monthly, quarterly, semi-annually) depending on the requirements of management.**

19.6.4 **Budget committee should be wisely formed consisting people from different skill groups including who are financially literate. Budget committee will enjoy the highest authority for planning, formulating, and implementing budget.**

19.6.5 The major role of budgeting is to predict the most likely financial consequences of a given operating plan, which is outlined in an operating budget. These financial consequences are usually reflected in three pro forma financial statements: cash flow, statement of profit or loss and other comprehensive income and statement of financial position, which are called financial budgets.

19.6.6 Budgets serve five critical roles in the planning and control processes that are not fulfilled by any other management tool. For this reason, budgeting, when properly executed, remains an important management tool. The five critical roles are:

a) by projecting the most likely financial consequences of the current plan, budgets allow decision-makers to evaluate whether the current plans are acceptable;

b) by comparing the resource requirements of the current plan with the resources that are available, or will be made available, budgets help decision-makers identify resource bottlenecks in the current plan. More generally, budgeting forces managers to think ahead to anticipate opportunities and problems rather than reacting to them as they occur;

c) because budgets include profitability and resource use information, they provide a means of allocating constrained organization resources to the most profitable uses;

d) because budgets provide a means of internally communicating the organization's financial and operating objectives, they provide a basis for coordinating activities in the organization; and

e) when developed appropriately, such as under conditions of participative budgeting or using benchmarks from practice, budgets provide a standard against which realized operations can be compared. This facilitates the process of identifying possible inefficiencies in operations.

19.6.7 Budget can be of various types depending on underlying assumptions on which budget is prepared. A detail of classification is attached in Appendix 19A.

19.6.8 The budget should be designed in such a way that the decision-maker can easily evaluate the effect of key decisions or key parameter estimates on key results.

19.6.9 Once prepared, individual budgets and the master budget package should be validated and verified. That is, the following tests should be undertaken:

a) Each budget should be checked to ensure that it is, from the decision-makers perspective, complete with respect to what is modeled or included in the budget.

b) Users should evaluate each of the budgets to ensure that they reflect the issues implied by the organization's objectives and strategy and that they provide information that summarizes performance relevant to the organization's objectives.

c) The projections developed by the budgets should be checked against managerial intuition and experience as a broad test of their internal consistency.

d) The equations programmed into the budget software should be verified to ensure that the calculations actually undertaken are those that are expected.

19.6.10 The data assumptions underlying each budget should be challenged and evaluated. These data include estimates of sales, prices, costs, resource use, and resource availability.

19.6.11 **Budget bases should be updated at regular intervals by designated officials as approved by the budget committee.**

19.6.12 Moreover, research suggests, almost unequivocally, that stretch targets, which are targets that organization members perceive as difficult but achievable, provide the greatest motivation for individual and group performance.

19.6.13 Organizations can prepare and use a budget manual which provides a set of guidelines as to who is involved with the budgetary planning and control process, and how the process is to be conducted.

19.6.14 **Zero-based budgeting is desired, however, the standard doesn't restrict the use of traditional budgeting system.**

19.6.15 Budget should be prepared based on some budget formula which needs to be regularly updated to confirm the budget figure worthy.

19.6.16 The master budget process is an exercise in financial modeling. Therefore, the discussion and the standards discussed in this standard relating to financial models apply to budgets created in the master budget process. In particular, budgets created in the master budget process should be subject to the validity standards developed in this standard:

a) Individually, and as a group, the budgets should be complete. That is, they should capture all the relevant aspects of the planning process.

b) The scope and focus of the budgets should reflect the organization's objectives and how the decision-makers that use those budgets think about the problem being studied.

c) The internal calculations within each budget should be verified to ensure that they have been accurately programmed or entered into the software underlying the budget.

d) The data underlying the budget should be checked for accuracy and reasonableness. These data include price, sales, cost, resource use estimates, and resource availability estimates.

19.6.17 There are two broad tests that relate to validating a financial model. The first test is for completeness. This means that the master budget should include all the elements of the planning and control process. The test for completeness involves asking decision makers whether there are any elements of either the master budget or an individual budget that are not included in the model. The second test is for representational faithfulness. This involves ensuring that the master budget and the individual budgets reflect the way that decision makers think about the budget problem. Also, designers must verify whether the budgets focus on variables that are critical to the organization's success as defined by the organization's objectives and chosen strategy. The best test of representational faithfulness is to put the budgets in the hands of the users and to identify whether the models meet their requirements.

19.6.18 Each budget should be tested for accuracy, which refers to the integrity of the formulas entered into the budget software that make the calculations. The preferred test for accuracy is a consistency check of individual parts of the budget by comparing known results against the budget's computed results. A secondary test for accuracy is to subject the model's results to tests of reasonableness that reflect prior experience and intuition. This is a weaker test than the consistency check because experience and intuition may not be applied systematically and because, under new conditions, experience and intuition may be misleading.

19.6.19 Another required test is to identify the reasonableness of the parameter estimates including those of prices, sales, costs, supplier lead times, times to put new capacity (people or equipment) in place, resource use rates, and resource availability. Reasonableness tests are undertaken by evaluating the estimates themselves and the results that they generate. The estimates are evaluated by comparing them against historical, industry-wide, or benchmark standards. The results are evaluated by comparing them to those of comparable organizations or by extrapolating historical results after adjustments for changed circumstances.

19.6.20 **Flexible budget is desirable; however, the standard doesn't prohibit the use of fixed or static budget.**

19.6.21 Budget preparation mechanism should allow the simulation process with reference to some bases (e.g., sales volume) so that it can be exercised when needed.

19.6.22 **Budget process should encourage post budget evaluation with the actual result through a process like audit trial and there should be a formal appraisal process.**

19.6.23 The comparison between actual and planned results also provides a systematic basis for evaluating and revising beliefs, thereby laying the ground for improved forecasts in the future.

19.6.24 Budget package should include pro forma financial statements along with different standalone budget. Illustrative templates of pro forma financial statements are provided in Appendix 19B.

19.6.25 The forecast amounts included in pro forma financial statements can be determined using several different methods. Management may specify a target goal. Past trends may be extrapolated to the future. Past trends may be adjusted for anticipated changes in economic conditions, technology, industry demand and supply, etc. Amounts may be taken from cash or capital budgets or other relevant budgets operating budget of master budget. Finally, some amounts may merely be "plugs," as is the case when the amount of debt or equity financing is determined by the amount required to bring the statement of financial position into balance.

19.6.26 Preparing pro forma financial statements is a complicated iterative process, particularly when it comes to projecting amounts for capital expenditures, debt and equity financing, and the associated amortization and interest expenses. As well, it is often necessary to recast the statements when profitability projections prove to be below desirable goals or when expansion options are too optimistic given available financing.

19.6.27 Preparation of pro forma financial statements begins with preparation of a pro forma statement of profit or loss and other comprehensive income. Once the statement of profit or loss and other comprehensive income projections are complete, a pro forma statement of financial position may be prepared, in which case the statement of cash flows becomes a by-product of the statement of profit or loss and other comprehensive income and statement of financial position. Alternatively, preparation of the statement of profit or loss and other comprehensive income may be followed by development of a statement of cash flows, and the statement of financial position may be prepared last. A hybrid approach may also be used where some statement of financial position and statement of cash flows items are developed simultaneously.

19.7 Recording and Reporting

19.7.1 Organization should have a well designed budget manual explaining every detail with budget preparation, implementation, evaluation, and appraisal system to be complied with.

19.7.2 Regarding budget process, the following administrative details are required to reduce any confliction:

a) Members of budget committee and their relationship;
b) Target setting process for preparation of budget;
c) Validation process of budget figures;
d) Details on budget period, budget unit, policy for pro forma presentations etc; and
e) Budget review and appraisal process along with audit trial to evaluate the reasonableness and accuracy of the budget.

19.7.3 Regarding budgets, following records are highly desired for reporting internally as per requirement:

a) Financial formula or models based on which budget is prepared;
b) Non-repetitive information other that from financial modeling required for budgeting and preparing pro forma financial statements, e.g., capital expenditure, issuance or debt or equity etc.;
c) Pro forma financial statements in line with the templates provided in appendix;
d) Analysis of variances and corrective actions taken;
e) Post-evaluation report; and
f) Any other reports as required by management in this regard.

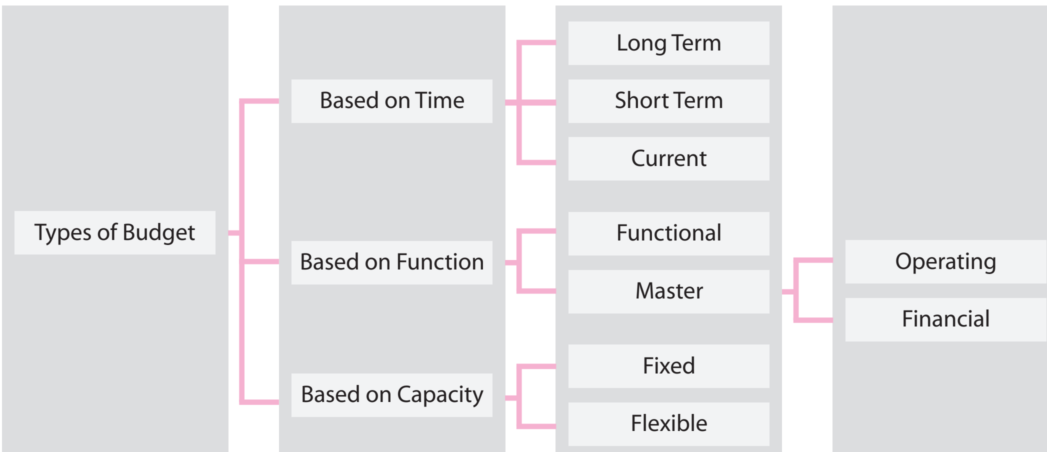
19.8 Effective Date

This standard will be effective from January 1, 2017 onwards.

Appendix 19A

Classification of Budgets

Budgets can be classed from various perspectives as outline in the figure below followed by a brief explanation.



Based on Time

a) Long-Term Budgets: Long-term budgets are prepared for a longer period varies between five to ten years. It is usually developed by the top level management. These budgets summarize the general plan of operations and its expected consequences. Long-Term Budgets are prepared for important activities like composition of its capital expenditure, new product development and research, long-term finance etc.

b) Short-Term Budgets: These budgets are usually prepared for a period of one year. Sometimes they may be prepared for shorter period as for quarterly or half yearly. The scope of budgeting activity may vary considerably among different organization.

c) Current Budgets: Current budgets are prepared for the current operations of the business. The planning period of a budget is generally set in months or weeks. As per ICMA London, "Current budget is a budget which is established for use over a short period of time and related to current conditions."

Based on Function

a) Functional Budget: The functional budget is one which relates to any of the functions of an organization. The number of functional budgets depends upon the size and nature of business. The following are the commonly used functional classification for budget purpose:

i) Sales Budget
ii) Purchase Budget
iii) Production Budget
iv) Selling and Distribution Cost Budget
v) Labor Cost Budget
vi) Cash Budget
vii) Capital Expenditure Budget

b) Master Budget: The Master Budget is a summary budget. This budget encompasses all the functional activities into one harmonious unit. The ICMA England defines a Master Budget as the summary budget incorporating its functional budgets, which is finally approved, adopted and employed. The following figure presents the Master Budget with interrelationship among the functional activities:

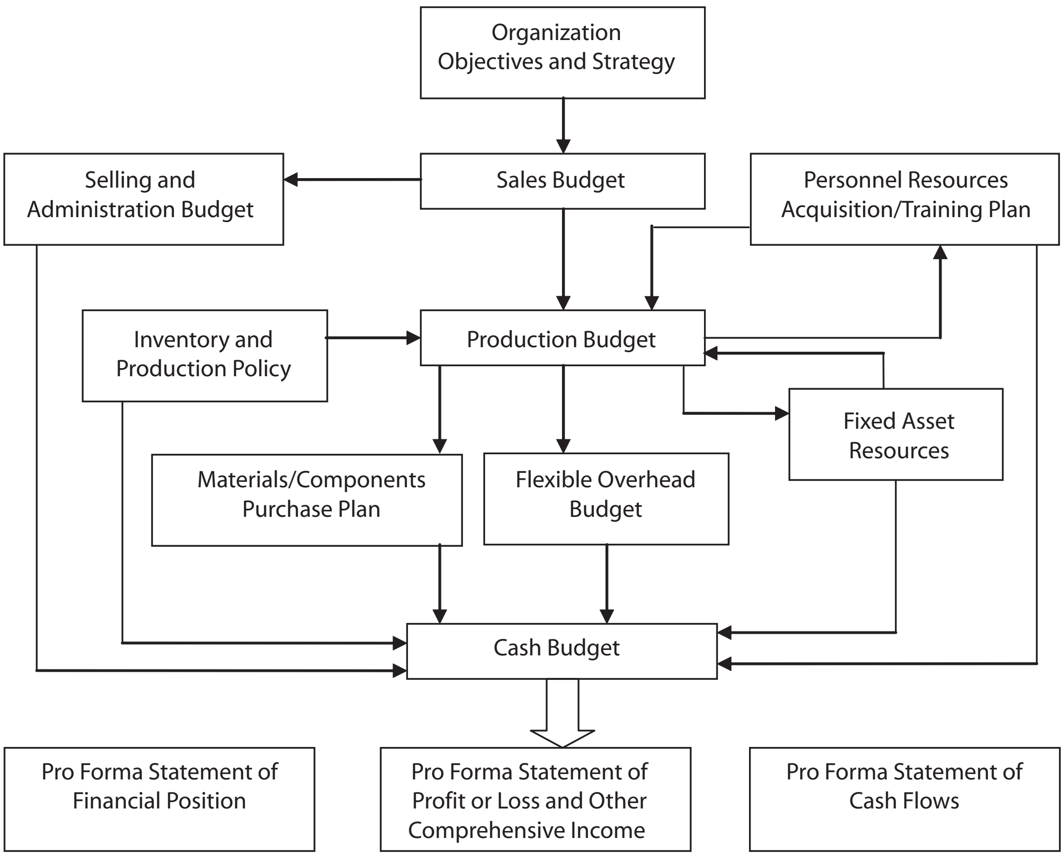


Figure: Major Components of Master Budget

There are two broad types of budgets within the master budget:

1. **Operating budgets** project and summarize the details of operations. Included in this group are all the elements above the dotted line; and
2. **Financial budgets** summarize the financial consequences of the operating budgets. These budgets include the pro forma statement of financial position, Statement of profit or loss and other comprehensive income, and statement of cash flows.

A critical design issue for the master budget is that it must reflect the organization's goals and strategies. That is, the master budget should clearly show how well the proposed operating plan achieves the organization's stated objectives.

Based on Capacity

a) **Static Budget:** A static budget is designed to remain unchanged irrespective of the level of activity actually attained.

b) Flexible Budget: A flexible budget is a dynamic budget which is designed to change in accordance with the various level of activity actually attained. The flexible budget also called as Variable Budget or Sliding Scale Budget, takes both fixed, variable and semi fixed manufacturing costs into account.

Appendix 19B

Illustrative templates for Pro Forma Financial Statements

This appendix presents some templates that may be customized and used for presenting pro forma financial statements (e.g., pro forma statement of financial position, pro forma statement of profit or loss and other comprehensive income, and pro forma statement of cash flow) along with supporting notes to be used by the preparers. Provisions have been made to present the statements in a comparative manner where current year's facts and figures (actual) can be presented along with the budgeted facts and figures for the budget period (next year). Even the pro forma statements can be extended further for one or two more years if the organizations like to forecast the courses of actions for a period covering more year(s). Even these expanded forms can be used as a tool for simulation showing the results by changing the bases in different economic scenarios (optimistic, most likely and pessimistic).

Statement of Profit or Loss and Other Comprehensive Income

Particulars	Notes	Actual 20X0	Pro Forma		
			20X1	20X2	20X3
Revenue					
Less: Cost of Goods Sold					
Gross Profit					
Operating Expenses:					
Marketing					
Research and Development					
General and Administrative					
Interest					
Amortization					
Total Operating Expenses					
Other Income (Expense)					
Non-continuing Items					
Income before Income Taxes					
Provision for Income taxes					
Income before accounting change					
Cumulative effect of accounting change					
Net Income					
Preferred stock dividends					
Net income available for common shareholders					
Basic earnings per share before accounting change					
Diluted earnings per share before accounting change					
Basic earnings per share					
Diluted earnings per share					

Prepared by: ....

Date: .... Executive Director: ....

Statement of Financial Position

Assets	Notes	Actual 20X0	Pro Forma		
			20X1	20X2	20X3
Current Assets					
Cash and cash equivalents					
Accounts receivable					
Short term investments					
Inventories					
Prepaid expenses					
Total current assets					
Property, Plant and Equipment, net					
Equity and other investments					
Goodwill					
Intangible assets, net					
Other long-term assets					
Total Assets					
Liabilities & Shareholders' Equity					
Current Liabilities					
Operating loan					
Accounts payable					
Accrued liabilities					
Taxes payable					
Current portion of long-term loan					
Others					
Total current liabilities					
Long Term Loan					
Other long term liabilities					
Total Liabilities					
Shareholders' Equity					
Common shares					
Retained earnings					
Total Liabilities & Shareholders' Equity					

Prepared by: ....

Date: .... Executive Director: ....

Statement of Cash Flows

Particulars	Notes	Actual 20X0	Pro Forma 20X1	Pro Forma 20X2	Pro Forma 20X3
Cash provided/used by Operating Activities					
Net income					
Adjustments to reconcile net income to net cash from operations:					
Depreciation, amortization, and other					
Stock-based compensation expense					
Net recognized gains on investments and derivatives					
Excess tax benefits from stock-based compensation					
Deferred income taxes					
Deferral of unearned revenue					
Recognition of unearned revenue					
Changes in operating assets and liabilities:					
Accounts receivable					
Inventories					
Other current assets					
Other long-term assets					
Accounts payable					
Other current liabilities					
Other long-term liabilities					
Net cash from operations					
Cash provided/used by Investing Activities					
Additions to property and equipment					
Acquisition of companies, net of cash acquired, and purchases of intangible and other assets					
Purchases of investments					
Maturities of investments					
Sales of investments					
Securities lending payable					
Net cash used in investing					
Cash provided/used by Financing Activities					
Short-term debt repayments					
Proceeds from issuance of debt					
Repayments of debt					
Common stock issued					
Common stock repurchased					
Common stock cash dividends paid					
Excess tax benefits from stock-based compensation					
Other					
Net cash used in financing					
Effect of exchange rates on cash and cash equivalents					
Net change in cash and cash equivalents					
Cash and cash equivalents, beginning of period					
Cash and cash equivalents, end of period					

Prepared by: ....

Date: .... Executive Director: ....