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Case Study

The role of budgets in forecasting financial risks in industrial companies

(Petro bash co. ltd. case study)

Abdelrahman Omer Ahmed Mohamed[1], Mazin Badreldin Omer Elhag Musa[2*]

1 Department of Accounting & Finance, University of Bahri, Khartoum, Sudan
2 Program of Accounting & Finance, Canadian Sudanese college , Khartoum, Sudan

* **Correspondence author: Dr.** Mazin Badreldin Omer Elhag Musa, Assistant professor, Program of Accounting & Finance, Canadian Sudanese college , Khartoum, Sudan.

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Abstract

The study deals with the role of budgets in anticipating future financial risks, the problem of the study is how budgets can help in discovering financial problems, the study aimed to determine the importance of comprehensive budgets and their role in anticipating financial deviations, the study used both the descriptive and analytical approaches , the study concluded that understanding financial risks , leads to an increased focus on the importance of financial projections, the financial manager of the company is responsible for the decision of financial risks forecasting, the gathering and communication of master budget information useful to forecast the financial risks and applying the planning and control the costs system to help the financial managers to estimates the cost of products and services to support the future expectation strategy of financial risks.

The study concluded that the financial manager of the company is responsible for the decision of financial risks forecasting ,the gathering and communication of master budget information useful to forecast the financial risks and the influence characteristics of master budget information are useful to expect and forecast the financial risks.

the study recommended that all industrial companies should apply appropriate budgetary processes, techniques and tools to be used to improve value of anticipating financial risks.

Keywords: Budgets, Financial Risks , Planning .

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INTRODUCTION

A budget allocates financial resources within the government to fund the operating and capital plans. The budget should be a communications device for officials to openly discuss the priorities with the public.

Markets move more quickly than ever before, use of technology is getting increased and competition is also became more complex due the expansion of the global market this and more factors generates a huge pressure on organizations and the need to build and generate forecasts . Organizations needs indicators on how external factors are impacting their business in order to improving the performance, if companies could obtain that better steer and translate it into an effective PBF process, they could gain a distinct competitive advantage.

Definition of Budgeting:

A budget enables resource allocation to be aligned to strategic goals and targets set across the entire organization.

Forecasting:

A forecast that tracks the expected performance of the business, so that timely decisions can be taken to address shortfalls against target, or maximize an emerging opportunity.

The system is considered as a tool to help the Management to plan and rationalize usage of the financial resources pursuant to criteria prepared in advance, and to supervise the execution in the situation of the limited resources.

Many studies showed that the Managers prefer using planned budgets because it spares a lot of time, work, and money, and it enables them to use the resources at hand ideally, and helps to make future forecasts through exploiting the opportunities, and lessening the risks that confront the plant by the correct understanding of the environment around the plant.

The Problem of study:

Which is represented by the following questions:

1. What is the importance of budget in forcasting risks?
2. How the budgeting forecast financial risks?
3. Why do financial risks is forcasted?

The objectives of the Study:

Through analyzing the problems which were referred to in the study, the study intends to substantiate the following objectives:

1. Identifying the important of budgeting in forecasting future financial problems.
2. To explain the relationship between the budgeting and forecasting financial riskss.
3. To help industrial organization in addressing their future financial problems.

The study hypothesis:

The research is based on a group of hypotheses summarized in the following:

H1 The financial problems lead to an increase in the importance of the budgeting in forecasting.

H2 Forecasting of financial risks require accurate and efficient budget preparation .

H3 The budgeting in forecasting helps industrial organization to avoid their future financial problems.

The importance of the Study:

1. It aims at identifying the way used to forecast the financial problems through budget.
2. The merits acquired by the various industrial institutions due to participation of many administrations in making the budgets.
3. Evaluation of the budgets in accordance with the scientific principles concomitant with the system of the budgets.

Literature reviewing

The concept of budgeting:

Budgeting control has been widely accepted as management techniques which are aimed at controlling the operations of an enterprise towards the realization of predetermined objectives. Organizations are structured into various departments according to individual requirement with specific targets set at each unit for the attainment of corporate objectives. Budgeting control system is a decision process premised on coordinating and controlling various activities within the divisional levels such that the overall corporate goal is achieved.

Budgeting is of age as the world itself, as it was used to check the kings power over taxation and to control government expenditure. The benefits of budgeting control is presently been used as an essential tool for planning the limited resources in any organization as well as the economy in general. Budgeting control though has received wide acceptance because of its crucial importance to government and organizations; it’s controversial nature can general conflicts, frustration and accurate competition from the core organizational resources. Budgeting is a good setting strategy where conflicts, power differentials and uncertainty are inherent, the system influenced behavior and action positively and negatively, unfortunately, when control breakdown rather than seeking solutions, some executives are lamed yet others indulge in disclaiming responsibilities. Budgeting simply implies a political statement aimed at attaining certain economic and social welfare goal by the government or the agencies involved. Budgeting is a series of goals. A more inclusive definition of budget has been given as a plan quantified in monetary terms to be prepared and approved prior to a defined period of time usually showing planned income to be generated and expenditure to be incurred during that period and the capital to be employed to attain a given objective. Budgeting system encourages active concern for the future delegation of responsibilities, authority and influence in organization. There should be adequate organizational structure to form a foundation for a sound budgeting system.

Management should maintain a level of authority and responsibilities, a good communication network, proper departmentalization and good relation. Management must however be contented with behavior of customers, government agencies, trade unions, customs, economic climate and political, which are considered to be external influence Budgeting system could assist the management in planning, co-coordinating, inter-relation activities and performance evaluation, planning as it is widely accepted in determination of objectives or setting targets, formulation of policies, strategies and alternative priorities. It involves critical examination and analysis of source and application of funds[1].

The objectives of budgeting:

The main objective of a firm is to make an excess of revenue over expenses to maximize profit. But it is not a matter of a dream or chance. There is no magic formula for boosting the figure of profit overnight. Budgeting can increase the chances of making profits within the given environment. Providing action plan, estimation of income and expenditure, guiding the management in forecasting and decision making etc. are some notable objectives of budget. **The main objectives of budgets can be described as follows:**

1. Estimation of Income and Expenses**:**

A budget provides a realistic estimate of income and expenses for a period and of the financial position at the close of the period, so it have an effect in the value of the firm.

2. Action Plan

Budget provides a coordinated plan of action which is design to achieve the estimates reflected in the budget.

3. Comparing the Results

Another objective of a budget is to provide a comparison of actual results with those budgeted and an analysis and interpretation of deviations by areas of responsibility to indicate courses of corrective actions and to lead to improvement in future plans.

4.Providing guidance

Budget helps to provide a guide for management decisions in adjusting plans and objectives if there is an uncontrollable change condition.

5. Forecasting and Decision Making

It provides a ready basis for making forecasts during the budget period to guide management in making day to day decisions[2].

Types of budgeting:

There are four common types of budgets that companies use: incremental, activity-based, value proposition and zero-based. These four budgeting methods each have their own advantages and challenges, which will be discussed in more detail in this guide.

[1] Lawrence J. Gitman and John R. Forrester,A Survey of Capital Budgeting Techniques Used by Major U.S. Firms Financial Management journal ,Vol. 6, No.3 (Autumn, 1977), pp. 66-71.

[2] Patrick Rowland , Richard irons , capital budgeting (new York : Cambridge , 2002) p26.

1. Incremental budgeting:

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

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

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

It is also likely to ignore external drivers of activity and performance. For example, there is very high inflation in certain input costs. Incremental budgeting ignores any external factors and simply assumes the cost will grow by, for example, 10% this year[1].

2. Activity-based budgeting:

Activity-based budgeting is a top-down budgeting approach that determines the amount of inputs required to support the targets or outputs set by the company. For example, a company sets an output target of $100 million in revenues. The company will need to first determine the activities that need to be undertaken to meet the sales target, and then find out the costs of carrying out these activities[2].

3. Value proposition budgeting

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

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

Value proposition budgeting is really a mindset about making sure that everything that is included in the budget delivers value for the business. Value proposition budgeting aims to avoid unnecessary expenditures – although it is not as precisely aimed at that goal as our

[1] steven fienkler , capital budgeting concepts for managers (new York : sunders for publishing , (1992) p 12.

[2] Brent banhub , Activity based management for financial institutions (new jersey : companion publishing , 2009) p 12.

final budgeting option, zero-based budgeting[1].

4. Zero-based budgeting:

As one of the most commonly used budgeting methods, zero-based budgeting starts with the assumption that all department budgets are zero and must be rebuilt from scratch. Managers must be able to justify every single expense.

No expenditures are automatically "okayed". Zero-based budgeting is very tight, aiming to avoid any and all expenditures that are not considered absolutely essential to the company's successful (profitable) operation. This kind of bottom-up budgeting can be a highly effective way to "shake things up".

The zero-based approach is good to use when there is an urgent need for cost containment, for example, in a situation where a company is going through a financial restructuring or a major economic or market downturn that requires it to reduce the budget dramatically.

Zero-based budgeting is best suited for addressing discretionary costs rather than essential operating costs. However, it can be an extremely time-consuming approach, so many companies only use this approach occasionally.

Levels of Involvement in Budgeting Process:

We want buy-in and acceptance from the entire organization in the budgeting process, but we also want a well-defined budget and one that is not manipulated by people. There is always a trade-off between goal congruence and involvement. The three themes outlined below need to be taken into consideration with all types of budgets[2].

Imposed budgeting:

Imposed budgeting is a top-down process where executives adhere to a goal that they set for the company. Managers follow the goals and impose budget targets for activities and costs. It can be effective if a company is in a turnaround situation where they need to meet some difficult goals, but there might be very little goal congruence[3].

Negotiated budgeting:

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

Participative budgeting:

Participative budgeting is a roll-up approach where employees work from the bottom up to recommend targets to the executives. The

[1] Natalia Ermasova , capital management and budgeting in the public sector , (USA : IGI global for publishing , 2019) p 171.

[2] Robin Cooper, the changing practice of management accounting, march 1998, p 28.

[3] www.corporate finance institute.com

executives may provide some input, but they more or less take the recommendations as given by department managers and other

employees of the firm (within reason, of course). Operations are treated as autonomous subsidiaries and are given a lot of freedom to set up the budget[1].

Financial Risk

Financial risk is a term that can apply to businesses, government entities, the financial market as a whole, and the individual. This risk is the danger or possibility that shareholders, investors, or other financial stakeholders will lose money. There are several specific risk factors that can be categorized as a financial risk. Any risk is a hazard that produces damaging or unwanted results. Some more common and distinct financial risks include credit risk, liquidity risk, and operational risk. The Basics of Financial Risk Financial risk is a type of danger that can result in the loss of capital to interested parties. For governments, this can mean they are unable to control monetary policy and default on bonds or other debt issues. Corporations also face the possibility of default on debt they undertake but may also experience failure in an undertaking the causes a financial burden on the business. Individuals face financial risk when they make decisions that may jeopardize their income or ability to pay a debt they have assumed. Financial markets face financial risk due to various macroeconomic forces, changes to the market interest rate, and the possibility of default by sectors or large corporations. Financial risks are everywhere and come in many different sizes, affecting everyone. You should be aware of all financial risks. Knowing the dangers and how to protect yourself will not eliminate the risk, but it will mitigate their harm[2].

Other types of financial risks:

Financial risk generally relates to the odds of losing money. The financial risk most commonly referred to is the possibility that a company's cash flow will prove inadequate to meet its obligations. Financial risk can also apply to a government that defaults on its bonds. Credit risk, liquidity risk, asset-backed risk, foreign investment risk, equity risk, and currency risk are all common forms of financial risk. Investors can use a number of financial risk ratios to assess a company's prospects. Financial Risks for Businesses It is expensive to build a business from the ground up. At some point, in any company's life, they will need to seek outside capital to grow. This need for funding creates a financial risk to both the business and to any investors or stakeholders invested in the company.

Credit risk also known as default risk is the danger associated with borrowing money. Should the borrower become unable to repay the loan, they will default. Investors affected by credit risk suffer from decreased income from loan repayments, as well as lost principal and interest. Creditors may also experience a rise in costs for collection of the debt. When only one or a handful of

[1] George li , capital structure , (USA : international journal of a business , vol 20 , no 4 ,2015 p 30).

[2] Alice Lee , Financial Analysis Planning and Forecasting (USA :world scientific for publishing , second edition) p246.

companies are struggling it is known as a specific risk This danger, related to a company or small group of companies, includes issues related to capital structure, financial transactions, and exposure to default. The term is typically used to reflect an investor's uncertainty of collecting returns and the accompanying potential for monetary loss. Businesses can experience operational risk when they have poor management or flawed financial reasoning. Based on internal factors, this is the risk of failing to succeed in its undertakings[1].

Financial Risks for Governments ,Financial risk also refers to the possibility of a government losing control of their monetary policy and being unable or unwilling to control inflation and defaulting on its bonds or other debt issues. Governments issue debt in the form of bonds and note to fund wars, build bridges and other infrastructure and pay for its general day-to-day operations. The U.S. government debt—known as Treasury's—is considered one of the safest investments in the world. The list of governments that have defaulted on debt they issued includes Russia, Argentina, Greece, and Venezuela. Sometimes these entities will only delay debt payments or pay less than the agreed upon amount, either way, it causes financial risk to investors and other stakeholders. Financial Risks for the Market Several types of financial risk are tied to financial markets. As mentioned earlier, many circumstances can impact the financial market. As demonstrated during the 2007-2008 global financial crisis, when a critical sector of the market struggles it can impact the monetary wellbeing of the entire marketplace. During this time, businesses closed, investors lost fortunes, and governments were forced to rethink their monetary policy. However, many other events also impact the market. Volatility brings uncertainty about the fair value of market assets. Seen as a statistical measure, volatility reflects the confidence of the stakeholders that market returns match the actual valuation of individual assets and the marketplace as a whole. Measured as implied volatility (IV) and represented by a percentage, this statistical value indicates the bullish or bearish—market on the rise versus the market in decline—view of investments. Volatility or equity risk can cause abrupt price swings in shares of stock. Default and changes in the market interest rate can also pose a financial risk. Defaults happen mainly in the debt or bond market as companies or other issuers fail to pay their debt obligations, harming investors. Changes in the market interest rate can push individual securities into being unprofitable for investors, forcing them into lower paying debt securities or facing negative returns. Asset-backed risk is the chance that asset-backed securities—pools of various types of loans—may become volatile if the underlying securities also change in value. Sub-categories of asset-backed risk involve prepayment—the borrower paying off a debt early, thus ending the income stream from repayments—and significant changes in interest rates. Financial Risks for Individuals can face financial risk when they make poor decisions. This hazard can have wide-ranging causes from taking an unnecessary day off of work to investing in

[1] Previous reference p 248.

highly speculative investments. Every undertaking has exposure to risk dangers that cannot be controlled, but some are done without fully realizing the consequences.

Liquidity risk comes in two flavors for investors to fear. The first involves securities and assets that cannot be purchased or sold quickly enough to cut losses in a volatile market. Known as market liquidity risk this is a situation where there are few buyers but many sellers. The second risk is funding or cash flow liquidity risk. Funding liquidity risk is the possibility that a corporation will not have the capital to pay its debt, forcing it to default, and harming stakeholders.

Speculative risk is one where a profit or gain has an uncertain chance of success. Perhaps the investor did not conduct proper research before investing, reached too far for gains, or invested too large of a portion of their net worth into a single investment. Investors holding foreign currencies are exposed to currency risk because different factors, such as interest rate changes and monetary policy changes, can alter the calculated worth or the value of their money. Meanwhile, changes in prices because of market differences, political changes, natural calamities, diplomatic changes, or economic conflicts may cause volatile foreign investment conditions that may expose businesses and individuals to foreign investment risk.

Tools to Control Financial Risk Luckily there are many tools available to individuals, businesses, and governments that allow them to calculate the amount of financial risk they are taking on. The most common methods that investment professionals use to analyze risks associated with long-term investments—or the stock market as a whole—include fundamental analysis, technical analysis, and quantitative analysis.

Fundamental analysis is the process of measuring a security's intrinsic value by evaluating all aspects of the underlying business including the firm's assets and its earnings. Technical is the process of evaluating securities through statistics and looks at historical returns, trade volume, share prices, and other performance data. Quantitative is the evaluation of the historical performance of a company using specific financial ratio calculations. For example, when evaluating businesses, the debt-to-capital ratio measures the proportion of debt used given the total capital structure of the company. A high proportion of debt indicates a risky investment. Another ratio, the capital expenditure ratio, divides cash flow from operations by capital expenditures to see how much money a company will have left to keep the business running after it services its debt.

In terms of action, professional money managers, traders, individual investors, and corporate investment officers use hedging techniques to reduce their exposure to various risks. Hedging against investment risk means strategically using instruments—such as options contracts—to offset the chance of any adverse price movements. In other words, you hedge one investment by making another[1].

The Relationship Between the Budgeting and Financial Risks

The concept of financial risks does not always implicitly carry a negative connotation. where investments are concerned (both capital investments and security investments). The financial risk is risk that cannot be measured. for example, we may or may not have information about the historical returns on a particular investment or on similar investments. if no information is available about historical returns or expenses for a particular investment, we are in the position of decision making under a condition of uncertainty [2]

Measures to forecast and mitigate financial risks :

1- Provide technical financial solutions.
2- Calculate and estimate the financial scenarios.
3- Deal with different types of budgeting.
4- Understand the sales and cash budget.

There are numerous kinds of risks to be taken into account when considering capital budgeting including: corporate risk, international risk (including currency risk),industry-specific risk, market risk, stand-alone risk, project-specific risk ,Each of these risks addresses an area in which some sort of volatility could forcibly alter the plan of firm managers. For example, market risk involves the risk of losses in position due to movement in market positions. There are different ways to measure and prepare to deal with risks as well. One such way is to conduct a sensitivity analysis. Sensitivity analysis is the study of how the uncertainty in the output of a model (numerical or otherwise) can be apportioned to different sources of uncertainty in the model input.

A related practice is uncertainty analysis which focuses rather on quantifying uncertainty in model output. Ideally, uncertainty and sensitivity analysis should be run in tandem. Another method is scenario analysis, which involves the process of analyzing possible future events by considering alternative possible outcomes.

For example, a financial institution might attempt to forecast several possible scenarios for the economy (e.g., rapid growth, moderate growth, slow growth), and it might also attempt to forecast financial market returns (for bonds, stocks, and cash) in each of those scenarios. It might consider sub-sets of each of the possibilities. It might further seek to determine correlations and assign probabilities to the scenarios. Then it will be in a position to consider how to distribute assets between asset types (i.e., asset allocation) The institution can also calculate the scenario weighted expected return (which figure will indicate the overall attractiveness of the financial environment). It may also perform financial stress testing, using adverse scenarios[3]

[1] Christopher Donhoui , foundations of financial risk , global association of risk professionals ,canada , 2015 , p 54

[2] Brian Hock , Lynn roden , financial reporting , planning , performance and control (Ohio : hock international for publishing , 2015) p 295.

[3] previous reference 297.

Data collection and Analysis

Budget and financial risks were measured by interview questions that were answered by financial manager . The relationship between these variables was measured by the degree to which budget information is produced and disseminated in the listed manufacturing companies in, degree of carrying out master budget , degree of compliance with master budget and the detail of financial risks . In order to analyze the forecasting of financial risks , questions were asked to probe direction in growth in terms of profitability and revenues budget listed manufacturing companies in. In order to analyze the information, questions were asked to probe aspects of producing information which is positive for the manufacturing companies. Budget concept were probed by establishing whether there has been cases of forecasting the future financial risks by following appropriate budget practices and the financial risks measures in place. Financial risks evaluation was probed by establishing the accuracy of the analysis by which the manufacturing company's implement the financial risks methods to the budget costs has been carried out. Sales budget were probed by establishing whether management pursues budget quality management through the forcasting of financial risks steps.

Data was collected, coded, edited by deductive approach where used to examine the concept of master budget application and perceived Financial risks levels in the listed manufacturing companies.

. of the population who are conveniently available to provide this information.

The subjects selected just because they are easiest to asses and they are willing to participate in this research.

This interview technique is fast, inexpensive, easy and the subjects are readily available.

There are some respondents in this survey: Management accountant or individual who function as accountant in the organization and management accountant supervisor and some managers.

A different level of employees of this industrial company located in Khartoum was participated in this research.

This case study use this questions because it is very easy to get the information from the financial manager .

The main advantage of this method is that the researchers can collect all the completed responses within a short period.

Interview with financial manager in Petro bash Co.ltd:

Interview questions and answers :

Q 1 Whose responsible for the budget practices in petrobash industrial co.ltd?

Answer 1 : Budget is a part of the business's financial decision making, the financial Manager have to make decisions concerning the allocation of scarce economic resources. To try to ensure that these resources are allocated in an efficient manner, managers require economic information on which to base their decisions.

Q 2 what is the role of the budget system to provide the financial risk information?

The budget will involve information gathering and communication that useful to forecast the financial risks in the company.

The characteristics that influence the usefulness of master budget information in forecasting the financial risks .

Q 3 what is qualitative characteristics that influence the usefulness of budget information?

master budget information should be material and the benefits of providing the information should outweigh the costs, classifications of cost, budget and budgetary control.

One would seriously advocate that the typical business should produce no management accounting information, at the same time; no one would advocate that every item of information that could be seen as possessing one or more of the key characteristics should be produced, irrespective of the cost of producing it. The characteristics that influence the of financial risks information.

Q 4 what is Budget information help users to estimate financial risks in order to make better decisions?

managerial accounting and differ in important ways, which this interview explains. Also compares the budget information and financial risks practices used by manufacturing a company's merchandising company sells products without changing their condition. A manufacturing company buys raw materials and turns them into finished products for sale to customers.

A company earns revenues by providing services rather than products. The skills, tools, and techniques of budget developed for measuring a manufacturing company's activities apply to service companies as well. The case study concludes by explaining the flow of master budget and preparing the statement which forecast the future financial risks in the company.

Q 5 explain the Managerial accounting activities in petrobash company that provides financial and nonfinancial information to an organization's managers and other internal decision makers?

the purpose of budget (also called master budget) and compares it with financial risks. The main purpose of the managerial accounting system is to prepare general purpose activities. That budget information is contain of the information useful for internal decision makers who manage organizations.

Results, Recommendations and Conclusions

Results:

1. The financial manager of the company is responsible for the decision of financial risks forecasting.
2. The gathering and communication of master budget information useful to forecast the financial risks.
3. The influence characteristics of master budget information are useful to expect and forecast the financial risks.
4. Master budget information should benefit in control the future costs so

this help in forecasting the financial risks.

5. The comparison between the periods of budget help users in forecasting the financial problems.
6. The budget information is containing financial information help the financial managers in forecasting the financial risks.
7. The expenditure expectation activities enhance the process the financial risks forecast.

Recommendations:

1. The study recommends that all the manufacturing companies to apply the appropriate processes and techniques of budgets that are used to enhance value of financial risks forecasting.
2. The study recommends Petro bash company to implement the formulation Of budget strategy; master budget techniques to help develop and manage a firm's financial risks.
3. Applying the planning and control the costs system to help the financial managers to estimates the cost of products and services to support the future expectation strategy of financial risks.
4. All the management accountant (appointed by the chief of management accountant) must manages the financial budget and provides an analysis of financial risks information for the divisional manager.
5. We recommend the managerial accounting manager and the entire researcher to evaluate the budget performance of the management accountant and makes recommendations for costs risk.
6. Each management accountant must be responsible for product costs, sales, pricing, operating expenses and profit.
7. The method of financial budget provides further evidence of the degree of operational risks Control.

Conclusions:

budget practices are a new tool in the estimation of financial risks. Recently, it has been a steep increase in all application of forecasting manufacturing and non-manufacturing costs, manufacturing costs are no longer a minor cost item which can be pooled together with other costs; the use of master budget practices saves money and improves financial control.

budget practices have to be appropriate to the special needs of the industrial companies rather than be applied as a generic system. The costs and advantages of building such a system have to be considered and the scope of the managerial accounting practices properly selected.

Building the master budget practices incrementally is a general implementation strategy among the companies. According to the analysis, it can be found that adoption of master budget practices enhance the financial risks forecasting in manufacturing companies.

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