

Budgets and Budgetary Control



Learning Objectives

- Why organisation prepare forecast or budget
- Advantage and application of Budgets.
- Purposes and types of Budget
- Revolution and application of budget according to their function
- Modern development in Budgetary control system
- Performance appraisal after compare it with the Budget

Introduction

Budgeting has come to be accepted as an efficient method of short-term **planning and control**.

It is employed, no doubt, in **large business houses**, but even the **small businesses** are using it at least in some informal manner.

Through the budgets, a business wants to know clearly as to **what it proposes to do during an accounting period** or a part thereof.

Probably, the **greatest aid to good management** that has ever been devised is the use of budgets and budgetary control.

It is a versatile tool and has **helped managers cope with many problems including inflation**.

Budget Meaning

- A financial and/or quantitative statement, prepared and approved prior to define period of time, of the policy to be pursued during that period for the purpose of attaining a given objective.
- A budget is a predetermined statement of managerial policy during the given period which provides a standard for comparison with the results actually achieved.



Essentials of a Budget

It is prepared for a definite future period.

It is a statement prepared prior to a defined period of time.

The Budget is monetary and or quantitative statement of policy.

The Budget is a predetermined statement and its purpose is to attain a given objective.

Difference between Forecast and Budget

Forecasts

Forecasts is mainly concerned with **anticipated or probable events**

Forecasts may cover for **longer period or years**

Forecast is only a **tentative estimate**

Forecast results in **planning**

The function of forecast **ends with the forecast of likely events**

Forecast usually covers a **specific business function**

Forecasting does not act as a tool of controlling measurement.

Budget

Budget is related to **planned events**

Budget is planned or prepared for a **shorter period**

Budget is a **target fixed for a period.**

Result of planning **is budgeting**

The process of **budget starts where forecast ends** and converts it into a budget

Budget is prepared for **the business as a whole**

Purpose of budget is not merely a planning device but also a controlling tool.

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.

Accordingly, there cannot be budgetary control without budgets. Budgetary Control is a system which uses budgets as a means of planning and controlling.

Essentials of budgetary control

Establishment of objectives for each function and section of the organization.

Comparison of actual performance with budget.

Ascertainment of the causes for such deviations of actual from the budgeted performance.

Taking suitable corrective action from different available alternatives to achieve the desired objectives.

Objectives of Budgetary Control

Planning:

- A budget is a plan of action. Budgeting ensures a detailed plan of action for a business over a period of time.

Control:

- Control is necessary to ensure that plans and objectives are being achieved.
- Control follows planning and co-ordination.
- No control performance is possible without predetermined standards.
- Thus, budgetary control makes control possible by continuous measures against predetermined targets.
- If there is any variation between the budgeted performance and the actual performance, the same is subject to analysis and corrective action.

Organization for Budgetary Control

Organisation
Chart

Budget
Center

Budget
Officer

Budget
Committee

Budget
Manual

Budget
Period

Key Factor

Organisation Chart

- For the purpose of effective budgetary control, it is imperative on the part of each entity to have definite "plan of organization."
- This plan of organization is embodied in the organization chart.
- The organization chart explaining clearly the position of each executive's authority and responsibility of the firm.
- All the functional heads are entrusted with the responsibility of ensuring proper implementation of their respective departmental budgets.
- An organization chart for budgetary control is given showing clearly the type of budgets to be prepared by the functional heads.
- The chairman of the company is the overall in charge of the functions of the Budgeted Committee.
- A Budget Officer is the convener of the budget committee, who helps in co-ordination. The Purchase Manager, Production Manager, Sales Manager, Personnel Manager,
- Finance Manager and Account Manager are made responsible to prepare their budgets.

Budget Center

- A Budget Center is defined by the terminology as "a section of the organization of an undertaking defined for the purpose of budgetary control."
- For effective budgetary control budget centre or departments should be established for each of which budget will be set with the help of the head of the department concerned.

Budget Officer

- Budget Officer is usually some senior member of the accounting staff who controls the budgetary process.
- He does not prepare the budget himself, but facilitates and coordinates the budgeting activity.
- He assists the individual departmental heads and the budget committee, and ensures that their decisions are communicated to the appropriate people.

Budget Committee

- Budget Committee comprising of the Managing Director, the Production Manager, Sales Manager and Accountant.
- The main objectives of this committee is to agree on all departmental budgets, normal standard hours and allocations.
- In small concerns, the Budget Officer may co-ordinate the work for preparation and implementation of budgets.
- In large-scale concern a budget committee is setup for preparation of budgets and execution of budgetary control.

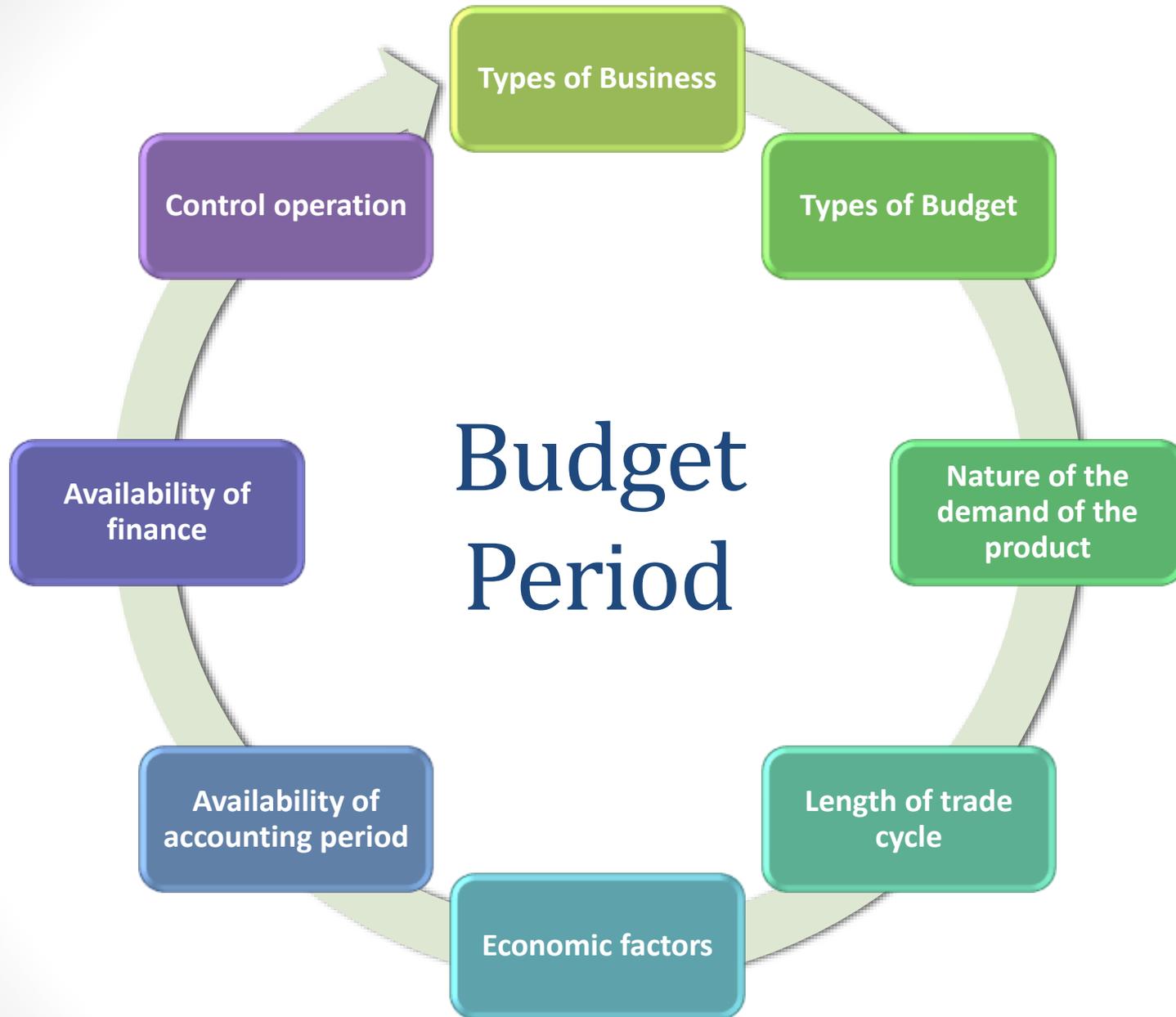
Budget Manual

- A Budget Manual has been defined as "a document which set out the responsibilities of persons engaged in the routine of and the forms and records required for budgetary control.
- It contains all details regarding the plan and procedures for its execution.
- It also specifies the time table for budget preparation to approval, details about responsibility, cost centers, constitution and organization of budget committee, duties and responsibilities of budget officer.

Budget Period

- A budget is always related to specified time period. The budget period is the length of time for which a budget is prepared and employed.
- The period may depend upon the type of budget.
- There is no specific period as such.

Budget Period



Key Factor

- Key Factor is also called as "Limiting Factor" or Governing Factor.
- While preparing the budget, it is necessary to consider key factor for successful budgetary control.
- The influence of the Key Factor which dominates the business operations in order to ensure that the functional budgets are reasonably capable of fulfilment.

Raw materials may be in. short supply.

Non-availability of skilled labours.

Government restrictions.

Limited sales due to insufficient sales promotion.

Shortage of power.

Underutilization of plant capacity.

Shortage of efficient executives.

Management policies regarding lack of capital.

Insufficient research into new product development.

Insufficiency due to shortage of space

Advantages of Budgetary Control

Facilitates reduction of cost

Guides the management in planning and formulation of policies

Facilitates effective co-ordination of activities of the various departments and functions by setting their limits and goals

Ensures maximization of profits through cost control and optimum utilization of resources.

Evaluates for the continuous review of performance of different budget centers.

Helps to the management efficient and economic production control.

Facilitates corrective actions, whenever there is inefficiencies and weaknesses comparing actual performance with budget.

Guides management in research and development.

Ensures economy in working.

Helps to adopt the principles of standard costing.

Dis-advantages of Budgetary Control

The budget plan is based on estimates and forecasting.

- Forecasting cannot be considered to be an exact science. If the budget plans are made on the basis of inaccurate forecasts then the budget programme may not be accurate and ineffective.

Uncertainty in future

- Changing circumstances may develop later on, budget may prove short or excess of actual requirements.

Effective implementation of budgetary control

- It depends upon willingness, co-operation and understanding among people reasonable for execution.
- Lack of co-operation leads to inefficient performance.

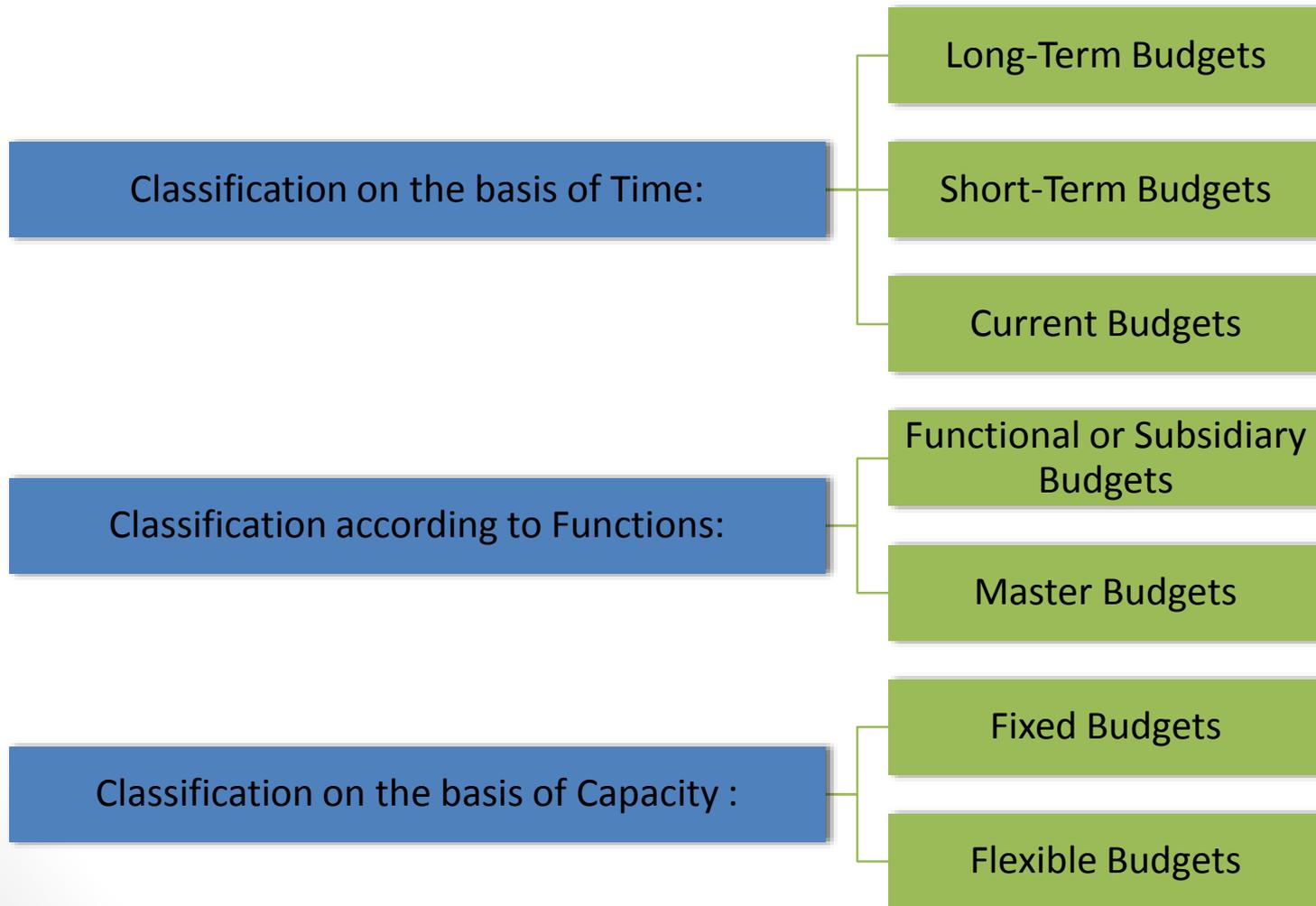
The system does not substitute for management.

- It is mere like a management tool.

Budgeting may be cumbersome

- It is a time consuming process

Types of Budgets



Classification on the Basis of Time

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 summarise **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**

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**.

Current Budgets

- Current budgets are prepared for the **current operations of the business**.
- Current budget is a budget which is established for use over a **short period of time and related to current conditions**."

Classification on the Basis of Function

Functional Budget:

- The functional budget is one which relates to **any of the functions** of an organization.
- The number of functional budgets depend upon the **size and nature of business**.
- The following are the commonly used:
 - **Sales Budget**
 - **Purchase Budget**
 - **Production Budget**
 - **Selling and Distribution Cost Budget**
 - **Labour Cost Budget**
 - **Cash Budget**
 - **Capital Expenditure Budget**

2. Master Budget:

- The Master Budget is a **summary** budget.
- This budget encompasses **all the functional activities** into one harmonious unit.
- It is the summary budget incorporating its functional budgets, which is finally approved, adopted and employed.

Classification on the Basis of Capacity

Fixed Budget

- A fixed budget is designed to **remain unchanged** irrespective of the **level of activity actually attained**.

Flexible Budget

- A flexible budget is a 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**
- It takes **both fixed, variable and semi fixed manufacturing costs** into account.

Control Ratios

Capacity Ratio:

- This ratio indicates the extent to which budgeted hours of activity is actually utilised
- **Capacity Ratio = Actual Hours Worked for Production / Budget Hours x 100**

Activity Ratio

- This ratio is used to measure the level of activity attained during the budget period.
- **Activity Ratio = Standard Hours for Actual Production / Budgeted Hours x 100**

Efficiency Ratio:

- This ratio shows the level of efficiency attained during the budget period
- **Efficiency Ratio = Standard Hours for Actual Production / Actual Hours Worked x 100**

Calendar Ratio:

- This ratio is used to measure the proportion of actual working days to budgeted working days in a budget period.
- **Calendar Ratio = Number of Actual Working Days in a Period / Budgeted Working Days for the Period x 100**

Sales Budget

- Sales Budget is one of the important functional budget.
- Sales estimate is the commencement of budgeting may be made in quantitative terms.
- Sales budget is primarily concerned with forecasting of **what products will be sold in what quantities and at what prices** during the budget period.
- Sales budget is prepared by the sales executives taking into account number of relevant and influencing factors such as :



Production Budget

- Production budget is usually prepared on the basis of sales budget.
- It also takes into account the **stock levels desired to be maintained**.
- The **estimated output of business firm** during a budget period will be forecast in production budget.
- It determines the **level of activity of the business** and facilities planning of production so as to maximum efficiency.
- It is prepared by the chief executives of the production department.
- While preparing the production budget, the factors carefully considered are



Cost of Production Budget

- After Preparation of production budget, this budget is prepared.
- Production Cost Budgets show the **cost of the production** determined in the production budget.
- Cost of Production Budget is grouped into
 - Material Cost Budget
 - Labour Cost Budget
 - Overhead Cost Budget
- Because it breaks up the cost of each product into three main elements material, labour and overheads.
- Overheads may be further subdivided in to
 - Fixed overheads
 - Variable overheads
 - Semi-fixed overheads
- Therefore separate budgets required for each item.

Material Purchase Budget

- The different level of material stock are based on planned out.
- Once the production budget is prepared, it is necessary to considered the requirement of materials to carryout the production activities.
- Material Purchase Budget is concerned with **purchase and requirement of direct materials to be made** during the budget period.
- While preparing the materials purchase budget, the following factors to be considered carefully:

Estimated sales and production.

Requirement of materials during budget period.

Expected changes in the prices of raw materials.

Different stock levels, EOQ etc.

Availability of raw materials, i.e., seasonal or otherwise.

Availability of financial resources.

Cash Budget

- This budget represent the anticipated receipts and payment of cash during the budget period.
- The cash budget also called as Functional Budget.
- Cash budget is the most important of all the functional budget because, cash is required for the purpose to meeting its current cash obligations.
- If at any time, a concern fails to meet its obligations, it will be technically insolvent.
- Therefore, this budget is prepared on the basis of detailed cash receipts and cash payments.

Estimated Cash Receipts

- **Cash Sales**
- **Credit Sales**
- **Collection from Sundry Debtors**
- **Bills Receivable**
- **Interest Received**
- **Income from Sale of Investment**
- **Commission Received**
- **Dividend Received**
- **Income from Non-Trading Operations etc.**

Estimated Cash Payments

- **Cash Purchase**
- **Payment to Creditors**
- **Payment of Wages**
- **Payments relate to Production Expenses**
- **Payments relate to Office and Administrative Expenses**
- **Payments relate to Selling and Distribution Expenses**
- **Any other payments relate to Revenue and Capital Expenditure**
- **Income Tax Payable, Dividend Payable etc.**

Master Budget

- When the functional budgets have been completed, the budget committee will prepare a Master Budget for the target of the concern.
- Accordingly a budget which is prepared incorporating the summaries of all functional budgets.
- It comprises of budgeted profit and loss account, budgeted balance sheet, budgeted production, sales and costs.
- Budget for the target of the concern.
- Accordingly a budget which is prepared incorporating the summaries of all functional budgets.
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Fixed Budget

- A budget is drawn for a particular level of activity is called fixed budget.
- Fixed budget is a budget which is designed to remain unchanged irrespective of the level of activity actually attained.
- Fixed budget is usually prepared before the beginning of the financial year.
- This type of budget is not going to highlight the cost variances due to the difference in the levels of activity.
- Fixed Budgets are suitable under static conditions.

Flexible Budget

- Flexible Budget is also called **Variable or Sliding Scale budget**
- It takes both the **fixed and manufacturing costs** into account
- Flexible budget is the opposite of static budget showing the **expected cost at a single level of activity.**
- Flexible Budget is a budget which is designed to change in accordance with the level of activity actually attained.
- According to the principles that guide the preparation of the flexible budget **a series of fixed budgets** are drawn for different levels of activity.
- A flexible budget often shows the budgeted expenses against each item of cost corresponding to the different levels of activity.
- This budget has come into use for solving the problems caused by the application of the fixed budget

Advantages of Flexible Budget

- In flexible budget, **all possible volume of output or level of activity** can be covered.
- Overhead costs are analysed into **fixed, variable and semi-variable costs**.
- Expenditure can be forecasted at different levels of activity and **related factor can be compared** which are essential for intelligent decision making.
- A flexible budget can be prepared with **standard costing or without standard costing** depending upon what the Company opts for.
- Flexible budget facilitates ascertainment of costs at different levels of **activity, price fixation, placing tenders and Quotations**.
- It helps in assessing the performance of all departmental heads as the same can be judged by terms of the level of activity attained by the business.

Method of Preparing Flexible Budget

Multi-Activity Method:

- This method involves **preparing a budget in response to different level of activity.**
- The different level of activity or capacity levels are shown in **Horizontal Columns**, and **the budgeted figures against such levels are placed in the Vertical Columns.**
- The expenses involved in production as per budget are grouped as **fixed, variable and semi variable.**

Ratio Method:

- According to this method, the budget is prepared first showing the **expected normal level of activity and the estimated variable cost per unit** at the side expected level of activity in addition to **the fixed cost as estimated.**
- Therefore, the expenses as per budget, allowed for a particular level of activity attained, will be calculated on the basis of the following formula : **Budgeted fixed cost + (Variable cost per unit of activity x Actual unit of activity)**

Charting Method:

- Under this method total expenses required for any level of activity, are estimated having classified into three categories, viz., **Variable. Semi Variable and Fixed.**
- These figures are plotted on a graph. The expenses are plotted on **the Y-axis and the level of activity are plotted on X-axis.**
- The graph will thus, help in ascertaining the quantum of budgeted expenses corresponding to the level of activity attained with the help of this chart.

Zero Base Budgeting (ZBB)

Zero Base Budgeting is a new technique of budgeting.

It is designed to meet the needs of the management in order to ensure the **operational efficiency** and **effective utilization of the allocated resources** of a concern.

This technique was originally developed by **Peter A. Phyhrr**, Manager of Texas Instrument during 1969.

This concept is widely used **in USA for controlling their state expenditure** when Mr. Jimmy Carter was the president of the USA.

At present the technique has for **its global recognition** for many countries have implemented in real terms.

Zero Base Budgeting: Meaning

According to Peter A. Phyrr ZBB is defined as an "Operative Planning and Budgeting Process" which requires **each Manager to justify his entire budget in detail from Scratch (hence zero base)** and shifts the burden of proof to each Manager to justify **why we should spend any money at all.**"

In zero-base budgeting, **a manager at all levels have to justify the importance of activity** and to **allocate the resources on priority basis.**

ZBB is defined as 'a method of budgeting which requires **each cost element to be specifically justified,** as though the activities to which the budget relates were being undertaken for the first time. **Without approval, the budget allowance is zero.**'

Zero – base budgeting is so called because it requires each budget to be **prepared and justified from zero, instead of simple using last year's budget as a base.**

Incremental level of expenditure on each activity are evaluated according to the resulting incremental benefits. **Available resources are then allocated** where they can be used most effectively

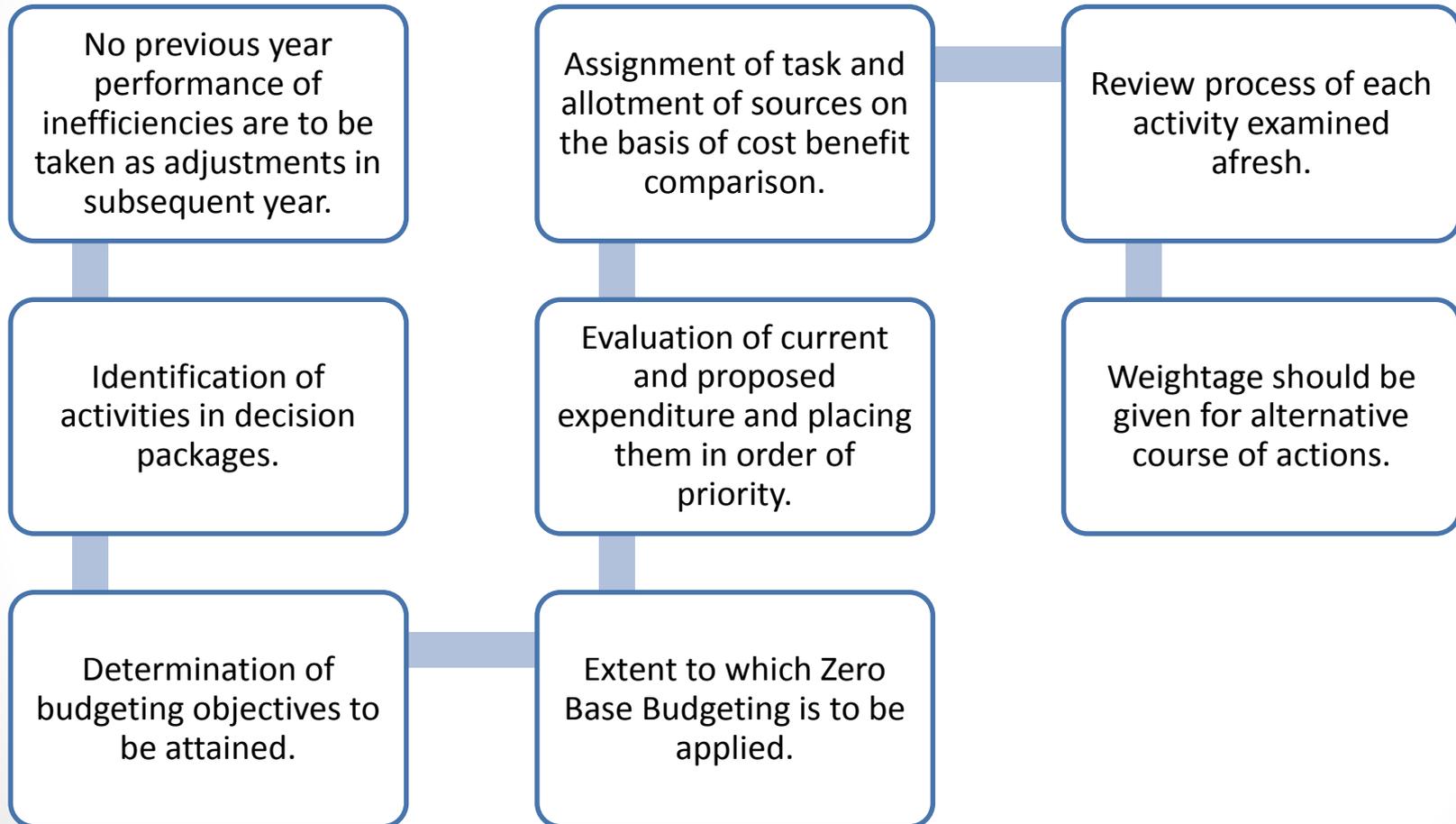
Important Aspects of ZBB

It emphasises on all requisites of budgets.

Evaluation on the basis of decision packages and systematic analysis, i.e., in view of cost benefit analysis.

Planning the activities, promotes operational efficiency and monitors the performance to achieve the objectives.

Steps Involved in ZBB



Advantages of ZBB

Utilization of resources at a maximum level.

It serves as a tool of management in formulating production planning.

It facilitates effective cost control.

It helps to identify the uneconomical activities.

It ensures the proper allocation of scarce resources on priority basis.

It helps to measure the operational inefficiencies and to take the corrective actions.

It ensures the principles of Management by Objectives.

It facilitates Co-operation and Co-ordination among all levels of management.

It ensures each activity is thoroughly examined on the basis of cost benefit analysis.

At end it should not be like this...



"Oops! My mistake. That was the yearly budget estimate, not the monthly estimate."

References

- <http://dosen.narotama.ac.id/wp-content/uploads/2013/02/Chapter-27-Budgeting-and-Budgetary-Control.pdf>
- <http://maaw.info/Chapter9.htm>