Budgeting and Budgetary Control

Introduction:

The term ‘Budget’ appears to have been derived from the French word ‘baguette’ which means ‘little bag' , or a container of documents and accounts. A budget is an accounting plan. It is a formal plan of action expressed in monetary terms. It could be seen as a statement of expected income and expenses under certain anticipated operating conditions. It is a quantified plan for future activities – quantitative blue print for action.

Every organization achieves itspurposes by coordinating different activities. For the execution of goals efficient planning of these activities is very importantandthat is why the management has a crucial role to play in drawing out the plans for its business. Various activities within a company should be synchronized by the preparation of plans of actions for future periods. These comprehensive plans are usually referred to as budgets. Budgeting is a management device used for short- term planning and control.It is not just accounting exercise.

Meaning and Definition:

Budget:

According to CIMA (Chartered Institute of Management Accountants) UK, a budget is“A plan quantified in monetary terms prepared and approved prior to a defined period of time, usually showing planned income to be generated and, expenditure to be incurred during the period and the capital to be employed to attain a given objective.”

In a view of Keller & Ferrara, “A budget is a plan of action to achieve stated objectives based on predetermined series of related assumptions.”

G.A.Welshstates, “A budget is a written plan covering projected activities of a firm for a definite time period.”

Budgetary Control:

Budgetary Control is a method of managing costs through preparation of budgets. Budgeting is thus only a part of the budgetary control. According to CIMA, “Budgetary control is the establishment of budgets relating to the responsibilities of executives of a policy and the continuous comparison of the actual with the budgeted results, either to secure by individual action, the objective of the policy or to provide a basis for its revision.”

Objectives

1) **Planning:**Planning has been defined as the design of a desired future position for an entity and it rests on the belief that the future position can be attained by uninterrupted management action. Detailed plans relating to production, sales, raw- material requirements, labour needs, capital additions, etc. are drawn out. By planning many problems estimated long before they arise and solution can be thought of through careful study. In short, budgeting forces the management to think ahead, to foresee and prepare for the anticipated conditions. Planning is a constant process since it requires constant revision with changing conditions.

2) **Co- ordination:** Budgeting plays a significant role in establishing and maintaining coordination. Budgeting assists managers in coordinating their efforts so that problems of the business are solved in harmony with the objectives of its divisions. Efficient planning and business contribute a lot in achieving the targets. Lack of co- ordination in an organization is observed when a department head is permitted to enlarge the department on the specific needs of that department only, although such development may negatively affect other departments and alter their performances. Thus, co- ordination is required at all vertical as well as horizontal levels.

3) **Measurement of Success:**Budgets present a useful means of informing managers how well they are performing in meeting targets they have previously helped to set. In many companies, there is a practice of rewarding employees on the basis of their accomplished low budget targets or promotion of a manager is linked to his budget success record. Success is determined by comparing the past performance witha previous period's performance.

4) **Motivation:**Budget is always considereda useful tool for encouraging managers to complete things in line with the business objectives. If individuals have intensely participated in the preparation of budgets, it acts as a strong motivating force to achieve the goals.

5) **Communication:** A budget serves as a means of communicating information within a firm. The standard budget copies are distributed to all management peoplethat provides not only sufficient understanding and knowledge of the programmes and guidelines to be followed but also gives knowledge about the restrictions to be adhered to.

6) **Control:** Control is essential to make sure that plans and objectives laid down in the budget are being achieved. Control, when applied to budgeting, as asystematized effort is to keep the management informed of whether planned performance is being achieved or not.

Advantages

1. This system provides basic policies for initiatives.
2. It enables the management to perform business in the most professional manner because budgets are prepared to get the optimum use of resources and the objectives framed.
3. It ensures team work and thus encourages the spirit of support and mutual understanding among the staff.
4. It increases production efficiency, eliminates waste and controls the costs.
5. It shows to the management where action is needed to remedy a position.
6. Budgeting also aids in obtaining bank credit.
7. It reviews the presentsituation and pinpoints the changes which are necessary.
8. With its help, tasks such as like planning, coordination and control happen effectively and efficiently.
9. It involves an advance planning which is looked upon with support by many credit agencies as a marker of sound management.

Limitations

1. It tends to bring about rigidity in operation, which is harmful. As budget estimates are quantitative expression of all relevant data, there is a tendency to attach some sort of rigidity or finality to them.
2. It being expensive is beyond the capacity of small undertakings. The mechanism of budgeting system is a detailed process involving too much time and costs.
3. Budgeting cannot take the position of management but it is only an instrument of management. 'The budget should be considered not as a master, but as a servant.' It is totally misconception to think that the introduction of budgeting alone is enough to ensure success and to security of future profits.
4. It sometimes leads to produce conflicts among the managers as each of them tries to take credit to achieve the budget targets.
5. Simple preparation of budget will not ensure its proper implementation. If it is not implemented properly, it may lower morale.
6. The installation and function of a budgetary control system is a costly affair as it requires employing the specialized staff and involves other expenditure which small companies may find difficult to incur.

Types of Budget:

Classification of Budget

1. **Functional Classification:**

a) Sales Budget
b) Production Budget
c) Raw Materials Budget
d) Purchase Budget
e) Labour Budget
f) Production Overhead Budget
g) Selling & Distribution Budget
h) Administration Cost Budget
i) Capital Expenditure Budget
j) Cash Budget

a. SALES BUDGET:

The sales budget is an estimate of total sales which may be articulated in financial or quantitative terms. It is normally forms the fundamental basis on which all other budgets are constructed. In practice, quantitative budget is prepared first then it is translated into economic terms. While preparing the Sales Budget, the Quantitative Budget is generally the starting point in the operation of budgetary control because sales become, more often than not, the principal budget factor. The factor to be consider in forecasting sales are as follows:

- Study of past sales to determine trends in the market.
- Estimates made by salesman various markets of company products.
- Changes of business policy and method.
- Government policy, controls, rules and Guidelines etc.

- Potential market and availability of material and supply.

b. PRODUCTION BUDGET:

The production budget is prepared on the basis of estimated production for budget period. Usually, the production budget is based on the sales budget. At the time of preparing the budget, the production manager will consider the physical facilities like plant, power, factory space, materials and labour, available for the period. Production budget envisages the production program for achieving the sales target. The budget may be expressed in terms of quantities or money or both. Production may be computed as follows:
Units to be produced = Desired closing stock of finished goods + Budgeted sales – Beginning stock of finished goods.

PRODUCTION COST BUDGET: This budget shows the estimated cost of production. The production budget demonstrates thecapacity of production. These capacities of production are expressed in terms of cost in production cost budget. The cost of production is shown in detail in respect of material cost, labour cost and factory overhead. Thus production cost budget is based upon Production Budget, Material Cost Budget, Labour Cost Budget and Factory overhead.

c. RAW- MATERIAL BUDGET:

Direct Materials budget is prepared with an intention to determine standard material cost per unit and consequently it involves quantities to be used and the rate per unit. This budget shows the estimated quantity of all the raw materials and components needed for production demanded by the production budget. Raw material serves the following purposes:

- It supports the purchasing department in scheduling the purchases.
- Requirement of raw- materials is decided on the basis of production budget.
- It provides data for raw material control.
- Helps in deciding terms and conditions of purchase like credit purchase, cash purchase, payment period etc.

It should be noted that raw material budget generally deals with only the direct materials whereas indirect materials and supplies are included in the overhead cost budget.

d. PURCHASE BUDGET:

Strategic planning of purchases offers one of the most importantareas of reduction cost in many concerns. This will consist of direct and indirect material and services. The purchasing budget may be expressed in terms of quantity or money.

The main purposes of this budget are:

- It designates cash requirement in respect of purchase to be made during budget period; and
- It is facilitates the purchasing department to plan its operations in time in respect of purchases so that long term forward contract may be organized.

e. LABOUR BUDGET:

Human resourcesare highly expensive item in the operation of an enterprise. Hence, likeother factors of production, the management should find out in advance personnel requirements for various jobs in the enterprise. This budget may be classified into labour requirement budget and labour recruitment budget. The labour necessities in the various job categories such as unskilled, semi- skilled and supervisory are determined with the help of all the head of the departments. The labour employment is made keeping in view the requirement of the job and its qualifications, the degree of skill and experience required and the rate of pay.

f. PRODUCTION OVERHEAD BUDGET:

The manufacturing overhead budget includes direct material, direct labour and indirect expenses. The production overhead budget represents the estimate of all the production overhead i.e. fixed, variable, and semi- variable to be incurred during the budget period. The reality that overheads include many different types of expenses creates considerable problems in:

1) Fixed overheads i.e., that which is to remain stable irrespective of vary in the volume of output,

2) Apportion of manufacturing overheads to products manufactured, semi variable cost i.e., thosewhich are partly variable and partly fixed.

3) Control of production overheads.

4) Variable overheads i.e., that which is likely to vary with the output.

The production overhead budget engages the preparation of overheads budget for each division of the factory as it is desirableto have estimates of manufacturing overheads prepared by those overheads to have the responsibility for incurring them. Service departments cost are projected and allocated to the production departments in the proportion of the services received by each department.

g. SELLING AND DISTRIBUTION COST BUDGET:

The Selling and Distribution Cost budget is estimating of the cost of selling, advertising, delivery of goods to customers etc. throughout the budget period. This budget is closely associated to sales budget in the logic that sales forecasts significantly influence the forecasts of these expenses. Nevertheless, all other linked information should also be taken into consideration in the preparation of selling and distribution budget. The sales manager is responsible for selling and distribution cost budget. Naturally, he prepares this budget with the help of managers of sub- divisions of the sales department. The preparation of this budget would be based on the analysis of the market condition by the management, advertising policies, research programs and many other factors. Some companies prepare aseparate advertising budget, particularly when spending on advertisements are quite high.

h. ADMINISTRATION COST BUDGET:

This budget includes the administrative costs for non- manufacturing business activities like director’s fees, managing directors’ salaries, office lightings, heating and air condition etc. Most of these expenses are fixed so they should not be too difficult to forecast. There are semi- variable expenses which get affected by the expected rise or fall in cost which should be taken into account. Generally, this budget is prepared in the form of fixed budget.

i. CAPITAL-   EXPENDITURE BUDGET:

This budget stands for the expenditure on all fixed assets for the duration of the budget period. This budget is normally prepared for a longer period than the other functional budgets. It includes such items as new buildings, land, machinery and intangible items like patents, etc. This budget is designed under the observation of the accountant which is supported by the plant engineer and other functional managers. At the time of preparation of the budget some important information should be observed:

- Overfilling on the production facilities of certain departments as revealed by the plant utilization budget.
- Long- term business policy with regard to technical developments.
- Potential demand for certain products.

j. CASH BUDGET:

The cash budget is a sketch of the business estimated cash inflows and outflows over a specific period of time. Cash budget is one of the most important and one of the last to be prepared. It is a detailed projection of cash receipts from all sources and cash payments for all purposes and the resultants cash balance during the budget. It is a mechanism for controlling and coordinating the fiscal side of business to ensure solvency and provides the basis for forecasting and financing required to cover up any deficiency in cash. Cash budget thus plays avital role in the financing management of a business undertaken.

Cash budget assists the management in determining the future liquidity requirements of the firm, forecasting for business of those needs, exercising control over cash. So, cash budget thus plays a vital role in the financial management of a business enterprise.

Function of Cash Budget:

- It makes sure that enough cash is available when it is required.
- It designates cash excesses and shortages so that steps may be taken in time to invest any excess cash or to borrow funds to meet any shortages.
- It shows whether capital expenditure could be financed internally.
- It provides funds for standard growth.
- It provides a sound basis to manage cash position.

2. Classification on Flexibility

a) FIXED BUDGET
b) FLEXIBLE BUDGET

1. FIXED BUDGET:

A fixed budget is prepared for one level of output and one set of condition. This is a budget in which targets are tightly fixed. It is known as a static budget. According to CIMA,"A budget which is designed to remain unchanged irrespective of the level of the activity attained". It is firm and prepared with the assumption that there will be no change in the budgeted level of motion. Thus, it does not provide room for any modification in expenditure due to the change in the projected conditions and activity. Fixed budgets are prepared well in advance.

This budget is not useful because the conditions go on the changing and cannot be expected to be firm. The management will not be in a position to assess, the performance of different heads on the basis of budgets prepared by them because to the budgeted level of activity. It is hardly of any use as a mechanism of budgetary control because it does not make any difference between fixed, semi- variable and variable costs and does not provide any space for alteration in the budgeted figures as a result of change in cost due to change in the level of activity. Fixed budget can be revised in the light of changing situations, yet the rigidity and control over costs and expenses would be lost in such cases. Fixed budgets should be prepared only where sales, production and costs can be accurately estimated.

2. FLEXIBLE BUDGET:

This is a dynamic budget. In comparison with a fixed budget, a flexible budget is one “which is designed to change in relation to the level of activity attained.” The underlying principle of flexibility is that a budget is of little use unless cost and revenue are related to the actual volume of production. The statistics range from the lowest to the highest probable percentages of operating activity in relation to the standard operating performance. Flexible budgets are a part of the feed advance process and as such are a useful part of planning. An equally accurate use of the flexible budgets is for the purposes of control.

Flexible budgeting has been developed with the objective of changing the budget figures so that they may correspond with the actual output achieved. It is more sensible and practical, because changes expected at different levels of activity are given due consideration. Thus a budget might be prepared for various levels of activity in accord with capacity utilization. Flexible budget may prove more useful in the following conditions:

- Where the level of activity varies from period to period.
- Where the business is new and as such it is difficult to forecast the demand.
- Where the organization is suffering from the shortage of any factor of production. For example, material, labour, etc. as the level of activity depends upon the availability of such a factor.

- Where the nature of business is such that sales go on changing.

- Where the changes in fashion or trend affects the production and sales.
- Where the organization introduces the new products or changes the patterns and designs of its products frequently.
- Where a large part of output is intended for the export.

3. Classification on Time Budget

With regard to time, budgets may be classified into four categories:

(a) Long- term Budget: These budgets are prepared on the basis of long- term projection and portray a long- range planning. These budgets generally cover plans for three to ten years. In this regard it is mostly prepared in terms of physical quantities rather than in monetary values.

(b) Short- term Budget: In this budget forecasts and plans are given in respect of its operations for a period of about one to five years. They are generally prepared in monetary units and are more specific than long- term budgets.

(c) Current Budgets: These budgets cover a very short period, may be a month or a quarter or maximum one year. The preparation of these budgets requires adjustments in short- term budgets to current conditions.

(d) Rolling Budgets:A few companies follow the practice of preparing a rolling or progressive budget. In this case companies prepare the budget for a year in advance. A new budget is prepared after the end of each month or quarter for a full year in advance. The figures for the month or quarter which has rolled down are dropped and the statistics for the next month or quarter are added.

Performance Budgeting (PB):

This term was used for the first time in the United States by the Hoover Commission. In India, Performance Budgeting was first discussed in 1954 during the Lok- Sabah debates. But it was only in 1961 that the government of India issued general orders drawing the attention of the administrative ministries to the recommendations of the Estimates Committee, and requesting them to consider the issuance of suitable instructions. It was left to the Administrative Reforms Commission to come out with more elaborate emphasis on PB in 1967.Performance budgeting is a budgeting system, which involves the assessment of the performance of the business, and both its specific and overall objectives. It gives clarity about organizational objectives and provides an exact direction to each employee in the business.

Meaning:

The term performance implies results or outputs. ‘ A performance budget is one which presents the purposes and objectives for which funds are required, the costs of the programmes proposed for achieving those objectives, and quantitative data measuring the accomplishments and work performed under programme. Thus, PB is a technique of presenting budgets for costs and revenues in terms of functions, programmes and activities and correlating the physical and financial aspects of the individual items comprising the budget.

As per the National Institute of Bank Management, PB technique is, "the process of analyzing, identifying, simplifying and crystallizing specific performance objectives of a job to be achieved over a period in the framework of the organizational objectives, the purpose and objectives of the job. The technique is characterized by its specific direction towards the business objectives of the organization." As a result, performance budget accentuates the execution of specific goals over a period of time.

Steps in PerformingBudgeting (PB):

- Establishment of performance targets
- Establishment of responsibility centre
- Estimating financial requirements
- Comparison of actual with budgeted performance
- Reporting and action