CHAPTER 3 BUDGETARY CONTROL

PART A: THEORY

❖ EXPLAIN BUDGET

A budget is a form of quantitative expression of policies, plans, objectives and goals laid down in advance by top management for the concern as a whole and for each sub-division thereof. A budget is a plan covering all phases of operations for a definite period in the future. A budget is a method for translating the goals and strategies of an organization into operational terms.

As per Chartered Institute of Management Accountants (CIMA), London, Budget is,
" A financial or quantitative statement, prepared and approved prior to a defined period of time of the policy to be pursued during that period for the purpose of attaining a given objective. It may include Income, Expenditure and Employment of Capital."

There are different types of budgets such as Sales Budget, Production Budget, Purchase Budget, Labour Cost Budget, Cash Budget and Flexible Budget.

❖ ESSENTIALS OF BUDGET

- It is prepared in advance and is based on future plans
- It is future oriented i.e. it is prepared keeping in mind the future requirements.
- It is expressed in monetary and quantitative terms
- Objectives and responsibilities should be clearly communicated to various levels of management.
- It is based on cash flow and it is used for implementation of policy.
- Budget should be monitored periodically

❖ CHARACTERISTICS OF BUDGET

- It is for a definite period.
- It is prepared in writing.
- It is a detailed plan for all economic activities.
- Co-operation from all departments is sought to be provided.
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- Budget is used to achieve business goals.
- Budget should be updated regularly.
- It is useful in planning, controlling and co-ordinating.
- Various types of budgets are prepared as per the needs of business.

❖ BUDGETING AND BUDGETARY CONTROL

Budgeting

Budgeting is the complete process of designing, implementing and operating budgets.

Budgetary Control

CIMA, London, defines Budgetary Control as:
"The establishment of budgets relating the responsibilities of executives to the requirements of policy and the continuous comparison of actual with budgeted results either to secure by individual action, the objective of that policy or to provide a basis for its revision."

❖ OBJECTIVES/USES OF BUDGETARY CONTROL

- It is used to achieve the targets set for the company.
- It is used to fix the responsibilities of executives, departments and personnel.
- It is used for comparison purpose.
- It is used to ensure the best use of all available resources.
- It is used for the purpose of co-ordination.
- It is used for revision purpose.
- It is used for long range plans.
- To reduce losses and wastes to the minimum.
- To bring out clearly where effort is needed to remedy the situation.
- It motivates employees if they are actively engaged in budget preparation.
- To see that the firm is not deflected from marching towards its long-term objectives without being overwhelmed by emergencies.
- It communicates goals of the organisation to the employees.

In Short, Budgetary Control means laying down monetary and quantitative terms of what exactly has to be done, how it is to be done, the actual results should not deviate much from the budgeted results, a course of action if results deviate and also fixing the responsibilities for various levels of management.

❖ ADVANTAGES OF BUDGETARY CONTROL SYSTEM

a) The use of budgetary control system enables the management of a business concern to conduct its business activities in the efficient manner.

b) It is a powerful instrument used by business houses for the control of their expenditure.

c) It provides a yardstick for measuring and evaluating the performance of their individuals and their departments.

d) It reveals the deviations to management from the budgeted figures after making a comparison with actual figures.

e) It helps in the review of current trends and framing of future policies.

f) It inculcates the feeling of cost consciousness among workers.

g) Management which have developed a well ordered budget plans and which operate accordingly, receive greater favour from credit agencies.

❖ LIMITATIONS OF BUDGETARY CONTROL SYSTEM

a) Based on estimates:

Budgets may or may not be true as they are based on estimates. Therefore, the adequacy or otherwise of budgetary control system, to a very large extent, depends upon the adequacy or accuracy with which estimates are made.

b) Time factor:

Budgets cannot be executed automatically. Accuracy in budgeting comes through experience. Management must not expect too much during the development period.

c) Co-operation required:

Staff co-operation is usually not available during budgetary control exercise. The success of the budgetary control depends upon willing co-operation and teamwork.

d) Expensive:

Its implementation is quite expensive. No budgetary programme can be successful unless adequate arrangements are made for supervision and administration.

e) Not a substitute for management:

Budget is only a managerial tool. It cannot substitute management.

❖ BUDGET CENTRE

Budget Centre is defined section of an organisation for which separate budgets can be prepared and control exercised. Thus if budgets are prepared department wise then each department is budget centre.

❖ BUDGET MANUAL

CIMA, London, defines it as,

‘”It is a document which sets out the responsibilities of the persons engaged in, the routine of and the forms and records required for budgetary control”.

The main idea behind the budget manual is to inform line executives beforehand about procedures to be followed rather than issuing frequent instructions from the controller’s office regarding procedures and forms to be used. Such frequent instructions can be a source of friction between the line and staff management. It is thus a formal record defining the functions and responsibilities of each executive. It standardizes the methods and procedures of budgetary control. There is synchronization of the efforts of all in an organization which result in maximization of profits.

Advantages of Budget Manual

- An overall well coordinated plan, provided by budgetary control system shows what role each manager is expected to play in maximizing the profits.
- Any problem arising in the working of a budgetary control system can be settled through the manual
- New employees get acquainted with the procedure involved in the operation of the system by referring to manual.
- Methods and procedures become standardized
- Since coordination is maintained, there is no overlapping of instructions. There is synchronization of all efforts which leads to the attainment of the objectives with minimum of friction.

❖ BUDGET COMMITTEE

In most of the organisations, there will be a budget committee under the chairmanship of Budget Controller who will submit the budget to the Chief Executive after co-ordination and preparation thereof.

The budget committee is a group of representatives of various functions in an organization. As all functions are inter-related and as any change in one’s target will have its impact on that of the other, it is necessary to discuss the targets so that a mutually agreed programme is finally decided. This is what is called coordination in budget-making. It is a powerful force in knitting together various activities of the business and enforcing real control over operations.

Budget controller has to co-ordinate with materials manager, personnel manager, production manager, maintenance manager, sales manager and R&D manager in preparation of all the functional budgets and finally the master budget, capital expenditure budget and cash budget.
These managers are the members of the committee and hence budget controller has to command respect, confidence and co-operation of all the members of the budget committee. The function of a budget officer is to assist the budget controller in preparation and finalization of budgets.

❖ FUNCTIONS OF BUDGET COMMITTEE

- To receive and scrutinize the budget proposals in respect of the various functional budgets.
- To assist the managers in preparation of budgets.
- To suggest changes and revise the budget proposals if necessary.
- To decide the detailed policy to be followed.
- To finalize the master budget and recommend it to the Chief Executive.
- To receive from time to time budget review comparing actual with the budgets.
- To locate and fix the responsibility for action.
- To suggest and take corrective action and remedial measures.
- To participate in discussions regarding new projects or programmes which have a bearing on new project.

❖ PRINCIPAL BUDGET FACTOR

Principal budget factor is defined as the factor which may be limited in supply and this fact must be considered in preparation of budget. It is also known as **Key Factor or Limiting Factor.**

Examples:

a) Scarce raw material
b) Shortage in skilled labour
c) Limited machine capacity
d) Limited capacity of plant and machinery
e) Shortage of Capital
f) Lack of market demand

❖ DIFFERENT TYPES OF BUDGET

Coverage wise budget:	Functional Budget Master Budget
Capacity wise budget:	Fixed budget Flexible budget
Condition wise budget:	Basic Budget Current Budget
Period wise budget:	Long term budget Short term budget Current budget
Function wise budget:	Sales budget Production budget Direct Material Purchase budget Direct Material Usage budget Direct labour budget Factory Overheads Budget Administration budget Selling and distribution budget Research and Development budget Cash budget Capital Expenditure Budget Plant utilisation budget

❖ MASTER BUDGET

Master Budget otherwise called Budgeted Profit and Loss Account is a summary of functional budgets and thus it shows the overall budget plan and profit or loss during the period. After preparation of initial Master Budget, budget officer should test whether it is within the realms of possibility. Common faults are to be rectified and final master budget is prepared and submitted to the budget committee. Budget Committee will discuss in a meeting and submit it to the board of directors for final approval. At this point, the budget becomes the management plan.

Explanatory note will be submitted to the board of directors explaining the reasons for variances in regard to the sales, cost of production and profit on the basis of information readily available in the functional budgets.

❖ FIXED BUDGET

A budget prepared on the basis of standard or fixed level of activity is known as fixed budget. It does not change with a change in the level of activities.

❖ FLEXIBLE BUDGET

The Chartered Institute of Management Accountants, London defines Flexible Budget,

"As a budget which by recognizing different cost behaviour patterns, is designed to change as volume of output changes."

It is a budget prepared in a manner so as to give the budgeted cost for any level of activity. It recognizing the difference between fixed, semi-fixed and variable cost is designed to change in relation to the activity attained. It is designed to furnish budgeted cost at any level of activity attained.

The main characteristic of flexible budget is that it shows the expenditure appropriate to various levels of output. If the volume changes, the expenditure appropriate to it can be established from the flexible budget for comparison with actual expenditure as a means of control. It provides a logical comparison of budget allowances with the actual cost. When flexible budget is prepared, actual cost of actual activity is compared with budgeted cost of actual activity, i.e., two things to a the same base.

❖ BASIC BUDGET

Basic budget has been defined as a budget which is prepared for use unaltered for a long period of time. This does not take into consideration current conditions and can be attainable under standard conditions.

❖ CURRENT BUDGET

A current budget can be defined as a budget which is related to the current conditions and is prepared for use for a short period of time. This budget is more useful than basic budget, as the target it lays down will be corrected to current conditions.

❖ LONG TERM BUDGETS

A long-term budget can be defined as a budget which is prepared for periods longer than a year. These budgets help in business forecasting and forward planning. Capital expenditure budgets and research developments budgets are good examples of long-term budgets

❖ SHORT TERM BUDGETS

This budget is defined as a budget which is prepared for a period less than a year and is very useful to lower levels of management for control purposes. In an ideal situation a short-term budget should perfectly fit into a long-term budget.

❖ ZERO BASE BUDGETING

CIMA defines Zero Base Budgeting as,

"a method of budgeting whereby all activities are re-evaluated each time a budget is set. Discrete levels of each activity are valued and a combination chosen to match funds available."

As the term suggests, it examines a programme or function or responsibility from scratch. The manager proposing this activity has, therefore, to prove that the activity is essential and the various amounts asked for are really reasonable taking into account the volume of activity. Zero base budgeting is based on the premise that every rupee of expenditure requires justification.

a) Zero base budgeting means budgeting from the beginning i.e. it is prepared without any reference to any base (past budgets and actual figures).

b) Zero Base budgeting may be defined as a planning and budgeting process which requires each manager to justify its budget in detail from scratch and justify why he should spend any money.

c) Concentration of efforts is not simply on "how much" a unit will spend but "why" it needs to spend

d) Under zero base budgeting, all activities are identified and evaluated by systematic analysis and ranked in order of importance.

e) Thus, the burden of proof is on manager to justify why the expenditure should be made at all and to indicate what would happen if the proposed activity is stopped and no expenditure is made.

f) Under zero base budgeting, all activities and costs are re-evaluated each time budget is set. It provides number of advantages to the organisational efficiency and effectiveness.

<u>Advantages:</u>

- It provides proper information for decision making.
- It focuses on future and not on past.
- It identifies unwanted activities and avoids wasteful expenditure.

<u>Disadvantages:</u>

- It involves more paperwork.
- Proper training of managers is required for successful operation of ZBB.
- It is time consuming.
- Cost of preparing and implementing ZBB is very high.

❖ PERFORMANCE BUDGETING

Performance budgeting involves evaluation of the performance of an organization in the context of both specific as well as overall objectives of the organization. This requires complete clarity about both the short-term as well as long-term organizational objectives.

The responsibility of the various levels of management should be predetermined in terms of results expected from them and the authority vested in them. In other words performance budgeting requires fixing of the responsibility of each executive in organization and the continuous appraisal of his performance. It is, therefore, considered to be synonymous with responsibility accounting.

The basic features of performance budgeting are:

a) Budget is prepared for each managerial level. The manager concerned is made responsible and held accountable for his performance at his level over the specified period of time.
b) The jurisdiction of the authority and responsibility for different costs controllable by the executive concerned is fixed up. In other words, each individual is held responsible for only such costs which are controllable by him.
c) The concerned executive is vested with the requisite authority required for the responsibility entrusted to him.

Objectives and Importance

a) Performance budgeting is mainly used in Government and public sector undertakings. It reflects government activities and expenditure thereon for the budget period.
b) The objective of performance budgeting are to provide a closer linkage between planning and action.
c) It is a technique of presenting budgets for costs and revenue in terms of functions.
d) Performance budgeting lays immediate stress on the achievement of specific goals.
e) Performance budgeting requires preparation of Periodic Performance Reports. Such reports compare budget and actual data and show any existing variances.
f) Performance budgeting reports are to be submitted at regular intervals to higher authorities showing the physical performance achieved, the expenditure incurred and variances.

❖ BUDGET VARIANCE

Budget versus actual analysis can provide insight as to what really happened in your business against what was expected. A budget is never going to be exact. Budgets typically uses rounded and estimated figures which are simply forecast.

The difference between the budgeted amount and actual amount is known as **Variance**.
If the difference is positive for the organisation, it will be known as **Favourable Variance.**
If the difference is negative for the organisation, it will be known as **Adverse Variance.**

Analysis of budget help us to provide insight for positive or negative variance. Negative variances can be caused by an efficiency problem, utilization problem, or due to unexpected or unavoidable occurrence whereas positive variance can provide insight as to why you did so well and what processes are working for your business.

Importance of Budget Variance

a) It aids as effective budgeting activity
b) It acts as a control mechanism
c) It fixes responsibility
d) It helps in identifying the changes which are needed in overall strategies
e) If there is no variance analysis, Budget loses its importance

PART B: PRACTICAL

SALES BUDGET, PRODUCTION BUDGET, PURCHASE BUDGET AND LABOUR COST BUDGET

1. XYZ Ltd manufactures three products P1, P2 and P3. These are made in three production departments from four materials M1, M2, M3 and M4.

Pre-determined product cost details:

Materials	Cost per material unit (Rs.)	Products		
		P1	**P2**	**P3**
		(Units per product)		
M1	0.50	-	1	2
M2	0.20	1	-	2
M3	0.25	2	1	-
M4	0.15	2	2	1

Budget Details	**P1**		**P2**		**P3**
Sales for the year (Rs.)	2,60,000		5,80,000		4,50,000
Selling price each	5		10		6
Stocks : Finished Products (units)					
At the beginning of the year	5,000		10,000		15,000
At the close of the year	10,000		15,000		30,000
Stocks: Raw materials(units)	**M1**	**M2**		**M3**	**M4**
At the beginning of the year - 1st Jan	30,000	40,000		10,000	60,000
At the close of the year – 31st Dec	40,000	30,000		20,000	60,000

The cost per unit of P1 = Rs. 2, P2 = Rs. 3, P3 = Rs. 5

Required to prepare:

a) Production budget b) Purchase budget

FLEXIBLE BUDGET

2. The expenses budgeted for production of 10,000 units in a factory are furnished below:

Particulars	**Per unit (Rs.)**
Materials	70
Labour	25
Variable Overheads	20
Fixed overheads (Rs. 1,00,000)	10
Other Variable overheads	5
Selling expenses (10% fixed)	13
Distribution expenses (20% fixed)	7
Administrative expenses (50,000)	5
Total Cost of sale per unit (to make and sell)	**155**

Prepare a budget for production of:

a) 8,000 units b) 7,000 units

CASH BUDGET

3. Prepare a cash budget for the three months ending 30th June, 2020 from the information given

Months	**Sales (Rs.)**	**Materials (Rs.)**	**Wages (Rs.)**	**Overheads (Rs.)**
uary	14,000	9,600	3,000	1,700
March	15,000	9,000	3,000	1,900
April	16,000	9,200	3,200	2,000
May	17,000	10,400	4,000	2,300
June	18,000	10,400	4,000	2,300

a) Credit Terms are:

i) Debtors: 10% sales are on cash. 50% of credit sales are collected next month and the balance in the following month.

ii) Creditors for:

Materials 2 months

Wages Paid 1/4 in same month & 3/4 in next month

Overheads 1/2 of a month

b) Cash and Bank Balance as on 1st April, 2020 is expected to be Rs. 6,000.

c) Other relevant information are:

i) Plant and machinery will be installed in February 2020 at a cost of Rs. 96,000
The monthly installment of Rs. 2,000 is payable from April onwards.

ii) Dividend @ 5% on Preference share capital of Rs. 2,00,000 will be paid on 1st June.

iii) Advances to be received for sale of vehicles Rs. 9,000 in June.

iv) Dividends from investment amounting to Rs. 1,000 are expected to be received in June.