UNIT-5

BUDGETING

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A Budget is a plan of action for a future period. Managerial actions that follow their decisions with regard to the aspects of business are based on a budget. The Budget pertaining to any of the activities of business is always forward-looking. It is prepared prior to a defined period of time

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The chartered Institute of management Accountants (CIMA), London defines budget as "A plan expressed in money. It is prepared and approved prior to the budget period and may show income, expenditure and the capital employed may be drawn up showing incremental effects on former budgeted and actual figures, or be compiled by zero-based budgeting"

Definition:-

"A Budget is an estimate of future needs arranged according to an orderly basis covering small or all of the activities of an enterprise for a definite period of time"

—George R. Terry

Essentials of a Budget are:-

→ It is prepared in advance and is based on a future plan of actions

→ It relates to a future period and is based on objective to be attained.

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→ It is a statement expressed in monetary and /or physical units prepared for the implementation of policy formulated by the management

Objectives of Budget:-

* To get more economic use of capital
* To prevent waste and reduce expenses
* To facilitate various departments to operate efficiently and economically
* To coordinate the activities of various departments
* To plan and control the income and expenditure of the firm
* To fix the responsibilities in different departments
* To ensure the availability of working capital
* To ensure the matching of sales with Production

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Purpose of Budget

The following are the purpose of Budget

(a) **Forecast of income and expenditure:-**

Budgeting is a critically important part of the business planning process. Business owners and managers need to be able to predict whether a business will make a profit or not. The purpose of budgeting is basically to provide a model of how the business might perform financially speaking if certain strategies, events, plans are carried out.

In constructing a Business plan, the manager attempts to forecast income and expenditure and thereby profitability

Business plan → Income → Profitability

Business plan → Expenses → Profitability

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(b) Tool for Decision making:-

The purpose of budgeting is to provide a financial framework for the decision making process i.e., is the proposed course action something we have in managing a business responsibly expenditure must be tightly controlled when the budget for advertising has been fully expended, the decision on "can we spend money on advertising" is likely to be "no".

(c) monitoring business performance:-

The purpose of budgeting is to enable the actual business performance to be measured against the forecast business performance i.e., is the business living up to our expectations

Variance is the difference between budgeted expenditure and actual expenditure

Features of a Budget:

It is a vital tool for carrying out effective short Term planning and control in firms

* Estimation of Business unit's profit potential:-

It shows how much profit or loss a business unit is expected to make and thereby reveals its profit potential

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* Appraisal of performance:-

At the end of a specified period actual performance is compared with the budget and deviations are ascertained. These deviations which are known as variances, are analysed by causes and responsibility centres

* Monetary terms:-

The figures in the budget are expressed in monetary terms. However, the monetary figures are supported by nonmonetary information namely units purchased, units manufactured, units sold etc

* Alteration of Approved Budget under specified conditions:-

After the budget has been approved by the top management the same cannot be altered except under special or specified conditions

* Review and Approval by a Higher Authority:-

The budget proposal which is prepared by the budgetee is reviewed and approved by an authority same or lower than the budgetee

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* Managerial commitment :-

The budget is essentially a commitment made by the manager of responsibility centres. They agree to shoulder responsibility for the purpose of achieving the budgeted objectives

Budgetary control

Budgetary control could be described as "forward costing" establishment of budgets and then their application with a view to ensure control over the activities of concern. The basic purpose is to improve the efficiency and profitability of the concern.

The Institute of cost and management Accountants, London, defines budgetary control as the establishment of budgets, relating the responsibilities of executive to the requirements of a policy and the continuous comparison of actual with budgeted results either to secure by individual action or to provide a firm basis for its revision.

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A Budgetary control system secures control over costs and performances in various parts of an enterprise by

* establishing budgets
* comparing actual results with budgeted one
* taking corrective action or revising the budget if necessary

Objectives of Budgetary control:

The following are the objectives of Budgetary control

→ To provide a detailed plan of action for a business over a period of time

→ To coordinate the different units and activities of the organisation with a view to utilise resources judiciously

→ To motivate organisational members to perform well

→ To exercise control on cost through comparison of actual results with budgeted ones and initiating rectificational steps promptly

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Forecast and Budget

Forecast is a statement of probable events. Budget is an operating and financial plan of a firm. At planning stage, it is essential to prepare forecasts of probable course of action for the business in future. plans or budgets are prepared on the basis of these forecasts. A forecast is, therefore the basis for the budget.

Differences between forecast and Budget

Forecast	Budget
* It is concerned with probable events	* It is concerned with planned events
* It is prepared for a long period	* It is usually prepared for each accounting period.
* It deals with only a limited activity of business eg., sale forecaste, purchase forecast	* It deals with the entire unit
* forecasting may not be very precise and it may lack control orientation	* It is definite and precise and is an important control tool
* It is a preliminary step in budgeting	* It begins when forecasting ends. Forecasts are converted into budgets

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Difference between Budgeting and Budgetary control:

Budgeting	Budgetary control
(1) Budgeting is the preparation in advance of the quantitative as well as financial statements to indicate the intention of the management in respect of the various aspects of the business	(1) Budgetary control is a system by which budgets are used as a means of planning and controlling all the aspects of a business
(2) Budget is a statement showing the probable items of work to be carried out by the various departments specifying the quantities and monetary values	(2) Budgetary control is a means of control by which the actual position is compared with that planned for to enable the management to take appropriate action if there are any deviations.
(3) Budget is a plan of operations expressed in monetary terms	(3) Budgetary control is the very essence of financial control
(4) It is an overall statement in financial terms of the plan of operations. It includes the sales to be	(4) Its main objective is to control all aspects of production and selling. The results revealed by

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made, the expenses to be incurred and the income to be received during the budget period	the budgets if found unsatisfactory indicates a need for change in policy itself
(5) Budget should be prepared by the department to which it relates	(5) Budgetary control in employed by a budget committee or controller

Objectives / functions of Budgeting

An effective Budgeting system is vital to the success of a business firm. Budgeting is needed in organizations to perform the following functions

(a) planning:-

planning is the setting of goals and the Preparation of budgets for achieving those goals. The budget is a formal planning framework that provides specific deadlines to achieve departmental objectives, and contributes towards overall objectives of an organization. A Budget incorporate expected performance and present managerial targets. Budgeting influences the formulation of all business strategies and subsequently assists business managers in executing such strategies

(b) coordination:-

coordination is a managerial function under which all factors of production and all departmental activities are balanced and integrated to achieve the objectives of the organization. Budget helps management to coordinate in the following ways

* The Existence of a well laid plan is the major step towards achieving coordination. Executives are forced to think of the relationship among individual operations and the company as a whole

* Budget helps to restrain the empire building efforts of executives. Budgets broaden individual thinking by helping to remove unconscious biases on the part of engineers, sales and production officers

* Budgets helps to search out weaknesses in the organizational structure. The formulation and administration of budgets isolate problems of communication of fixed responsibility and of working relationships

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(c) communication :-

It is necessary in an efficient organization that all people be informed about the objectives, policies, programs and performances. Budgets inform each manager of what others have agreed to do. They also inform managers of the resources available to achieve objectives and targets

(d) control and performance Evaluation :-

control is collecting feedback to ensure that a plan is implemented correctly or changed as situations change. Budgeting enters into control at 3 points

→ Then a budget is being formulated departments analyses their plans for the future and submit estimates as per their requirements, justifying each of their demands by demonstrating a need

→ After budget of different departments have been reviewed and approved they become targets that desirable limits on spending

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→ At the end of the budget period a comparison of actual expenditures with budget expenditure is made as a means of judging performance and fixing responsibility for deviations

Benefits of Budgeting:-

(a) standard performance:-

Budgets provide standards of performance for various periods and sub-periods. Actual performance can be compared against standards at frequent time intervals and timely correction of deviations can be made

(b) Budgets facilitate planning:-

Budget specify the time and amount to be spent by various departmental heads and therefore serve as the basis for making accurate and definite plans. Budgets are based on defined activities worthy of appraisal and change. Thus goals are achieved within the defined targets thereby optimising the use of resources

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(c) motivation and Job satisfaction:-

Operating managers participate in preparing the budgets. This increases their motivation, job satisfaction and efficiency of work

(d) Helps in predicting future:-

Budgets help in projecting the impact of future on operations of the firm. Environmental changes can therefore be incorporated in the organizational policies and procedures

(e) coordination:-

Budgetary control coordinates activities of various sub-units to bring them close to overall goals. For instance, sale budget has to be coordinated with purchase budget which further has to coordinate with labour budget. This requires free flow of information amongst various departments which helps to achieve coordination

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(f) Financial planning:-

Budgets help in planning financial activities by estimating the requirement of funds, sources from where funds will be raised and laying the plans, objectives and policies. This optimizes the use of funds and contributes to profitability of the firm

Limitations of Budgeting:-

(a) projections of future:-

Budgets are based on future prediction. If the events do not occur as projected, budgetary allocations will have to be reallocated. Thus, uncertainities in future can affect the reliability of budgets

(b) over emphasis on budgeted goals:-

Within the limits of budgeted goals managers may ignore overall goals of the organization and achieve the budgeted goals at the cost of organizational goals

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(c) over-spending:-

Sometimes, budgeted amounts remain un-utilized and are thus spent during the end of the budgeted time periods to maintain future allocations. This results in over spending and negatively affects organizational efficiency and objectives

(d) Based on past results:-

Though budgets highlight future projections past provides important foundation to prepare the budgets. Events which were not important in the past may not thus form part of future budgets if they happen to become important in future. This problem can also be overcome by making zero-base budgets where every important activities are reviewed for budgeted period which becomes part of the budgets

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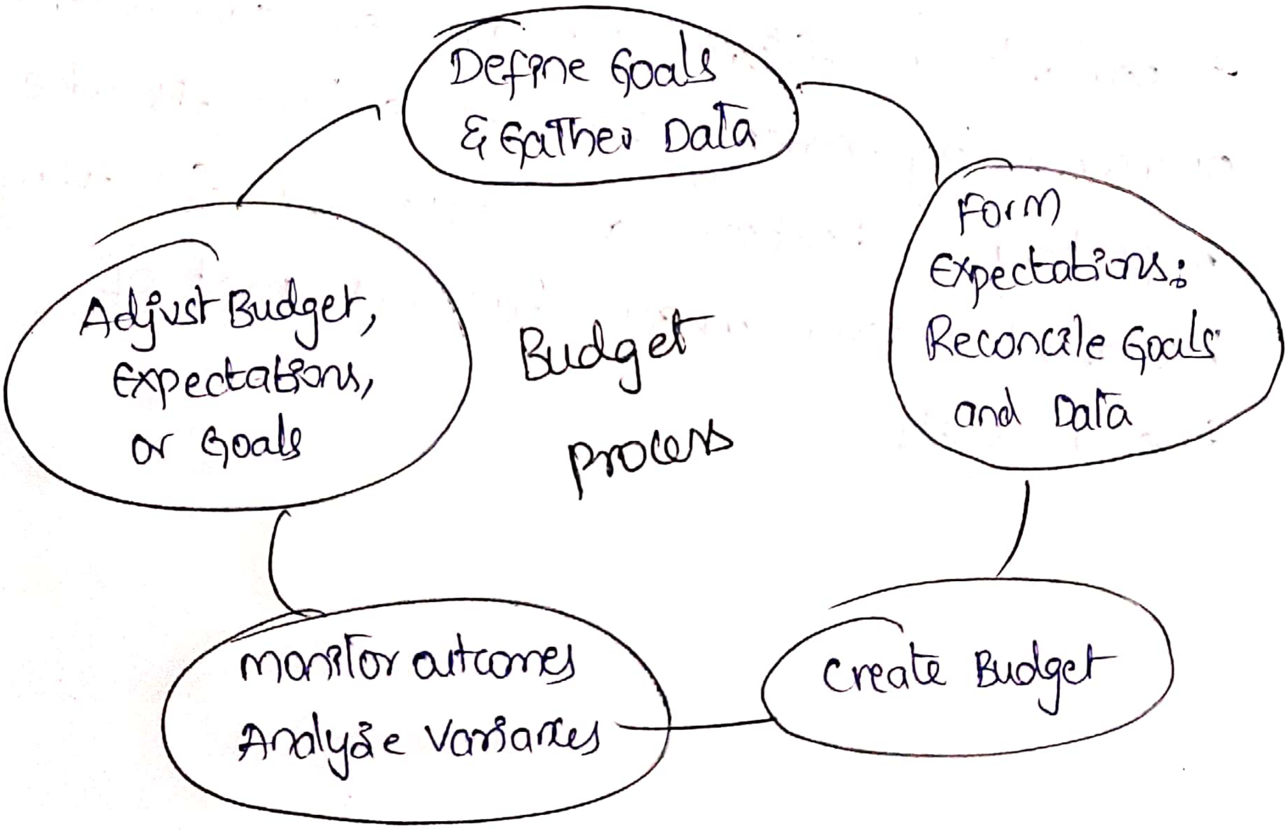
Budget process:

The Budget process is an infinite loop similar to the larger financial planning process. It involves

→ Defining goals and gathering data
→ Forming expectations and reconciling goals and data
→ creating the budget
→ monitoring actual outcomes and analyzing variances
→ adjusting budget, expectations or goals
→ redefining goals



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Budgetary control organization

The following steps should be considered in detail for sound budgets and for successful implementation of the budgetary control system:

Organisation for Budgeting:

(i) Budget Centre:-

The organisation must have a clear perspective of the objectives that are sought to be achieved through budgetary control. After outlining such objectives, budget centres must be established. A Budget centre is a section of an undertaking defined for the purpose of budgetary control. A Budget centre must be clearly demarcated to facilitate the formulation of various budgets with the help of the heads of the departments concerned.

Ex:- The production manager must be consulted for the preparation of the production budget. The responsibility of each executive must be clearly defined.

(ii) Budget manual:-

It is a written document or booklet

containing standing instructions regarding the procedures to be followed and the time schedules to be observed. It is usually maintained in a loose-leaf form so as to facilitate easy alterations from time-to-time. The main purpose behind the Budget manual is to inform line executives beforehand about the procedures to be followed rather than issuing frequent instructions from the controller's office and there by avoid friction between line and staff officials.

The Budget manual clearly states the functions of various officials connected with the formulation of budgets. It sets out various steps in preparation of various budgets including submission, review, approval and final adoption.. It also indicates the time table for budget operations and the records, reports and forms to be maintained for the purpose.

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Responsibility for Budgeting:-

Budget controller:-

The Budgetory control organisation is usually headed by a top executive known as Budget controller. He should be a man of wide experience and should possess through knowledge regarding budget matters, since he is expected to command the respect of all members in the organisation. The budget controller is a staff man providing advice to management on various important issues i.e., preparation of budgets, informing management of the need to revise budgets, collecting information as to how to the budgets could be operated more efficiently etc and is answerable to the chairman of the company directly

Budget committees:-

The Budget controller may have a budget committee under him to help in his work. It will have the representatives from various departments like production, finance, marketing, administration and accounts. The members of the committee discuss the budget figures thoroughly before coming out with a mutually agreed programme for the organisation.

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Fixation of the Budget period:-

Budget period:-

It refers to the period of time covered by a budget. The length of budget period depends on the nature of business, the production period, the control aspect etc. Industries experiencing a high rate of change generally go for annual budgets. whereas in industries like ship-building, the period of budget may vary between 5 to 10 years

Ex:- electronics, consumer goods industries

Determination of the key factors

Budget key factor:-

Key factor is also known as limiting factor or governing factor. It has been defined as the factor the extent of whose influence must first be assessed inorder to ensure that the functional budgets are reasonably capable of fulfilment. It proves to be an obstacle in the achievement of the targeted figures stated in the functional budgets. stated constrained in the functional budgets. otherwise, it is a factor of such importance

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that it influences all other budgets so that the consideration must be analysed first in the following are the examples of key factors:

(a) materials :- non-availability of supply, shortage of quality as well as quantity

(b) Labour :- shortage of skilled labour, problems of high turnover

(c) working capital :- shortage due to lack of funds inefficient use of working capital

(d) plant :- constraints of finance, space etc, shortage of plant capacity due to import restrictions.

(e) management :- Limited availability of expertise technical and managerial

Reporting on results:-

Budget Report:-

establishing budgets is in itself of no use unless a comparison is made regularly between actual performance and budgeted performance, and the results brought to the notice of management through reports. The budget reports should be prepared in such a that it influences all other budgets so that the coordination must be centered round it. The following are the examples of key-factors

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Types of Budget

Budget may be classified on the basis of scope, the capacity or efficiency to which they are related the condition on which they are based and the periods they cover.

The Budgets can be classified according to various points of view, the following basis of classification are generally followed in practice

(a) functional classification

(b) classification on the basis of time factor

(c) classification on the basis of flexibility

(a) Functional classification :-

A master budget is the summary budget for the entire enterprise and embodies the summarised figures for various activities. It is the consolidation of all functional budgets. A functional budget is a budget which relates to any of the functions of an undertaking

Eg:- Production, sales, finance etc

Sales Budget :-

The sales budget is a forecast of total sales expressed interms of money and quantity. In practice, quantitative budget is prepared first, then it is translated into monetary terms

Production Budget :-

It is a forecast of the production for the budget period. It may be expressed in units or standard hours. A standard hour is the quantity of output or amount of work which should be performed in one hour. while preparing the production budget, the production executive will take into account the physical facilities like plant, power, factory space, materials, labour availability for the period.

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Materials Budget:-

It shows the details of raw materials to be consumed. It is expressed in terms of physical quantities and values of materials to be issued from the stores for production purpose. This budget provides that right materials of right quantity and quality are procured.

Labour Budget:-

It shows the details of labour requirements in quantity with estimated costs. This budget gives detailed information relating to the number of employees, rates of wages and cost of labour hours to be employed.

Manufacturing overhead Budget:-

It shows the estimated costs of indirect materials, indirect labour and indirect manufacturing expenses during the budget period to achieve the predetermined targets

Administration cost Budget:-

This comprises the salaries and expenses of administrative office and management for a specified period. It is prepared with the help of past experience and expected changes in future.

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Selling Expenses Budget:-

All expenses concerned with sale of products to customers are included in this budget. It is generally prepared territory-wise by the sales manager of each territory, on the basis of past records

Research and Development Budget:-

This budget lists all the research and development activities together with their likely costs

cash Budget:-

It is prepared after all the functional budget are prepared by the chief accountant either on a monthly or weekly basis. It shows the sum total of the requirements of cash in respect of various functional budgets and of estimated cash receipts for a stipulated period

capital expenditure Budget:-

This Budget shows the estimated expenditure on fixed assets like plant, land, machinery, building etc. It is a long-term budget, usually set for 3to5 years. The budget requires frequent revision because of changes in cost of land, buildings, machinery and equipment. It gives an indication of the cash requirements. If financial resources

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are not available within the company, arrangements have to be made to raise them from outside. The following are the advantages of capital expenditure budget

(i) It estimates the capital expenditure requirements and accordingly provides or arranges for it

(ii) The priority of procuring assets can be determined Those assets which are very important and unavoidable is given first preference and others are postponed to a later period

(iii) It serves as a tool of controlling capital expenditure

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Master Budget:-

The master Budgets combine all functional budgets into one harmonious unit. It is a summary plan of overall proposed operations developed by management for the company, covering a specific period. It is a summary budget incorporating its functional budgets which is finally approved, adopted and employed. This budgeting contains the details of sales budget, production budget, cash budget etc. when it is complete, the budget committee will review all the details and if approved, it will be submitted to the board of directors. Once it is accepted and approved it becomes the target for the company during a specific period to achieve the desired targeted results

Master Budget → Combines the budget of different divisions of a business firm

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To determine the expected income and expenses in a financial Year

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Purpose of master budget :-

Understanding the purpose makes the
master budget definition and process clearer. It
is a planning tool used by the management to
direct and judge the performance of the various
responsibility centers that reside within an
organization to have proper control. This budget
undergoes multiple iterations before it gets
approved by the senior management to allocate
funds accordingly. This budget is prepared under
the guidance of the Budget director, which is
usually the controller of the company.

The central aspect to remember about
this budget is the sum of all the individual
budgets made within separate departments, thus
providing a vital link between sales, production,
and costs. It helps to ensure that all the
departments work together to achieve to common
objectives of the overall business.

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(b) classification according to time factor:-

In terms of time factor, budgets are broadly of the following 3 types

Long term Budgets:-

They are concerned with planning the operations of a firm over a perspective of 5 to 10 years. They are usually interms of physical quantities

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Short term Budget:-

They are usually for a period of a year or two and are in the nature of production plan in monetary terms

Current Budgets:-

They cover a period of month or so and they will be adjusted to current conditions or prevailing circumstances

(c) Budgets based on flexibility:-

On the basis of flexibility budgets may be classified into

Fixed Budget:-

Fixed Budget is a budget in which targets are rigidly fixed. Such budgets are usually prepared from 1 to 3 months in advance of the fiscal year to which they are applicable. Thus, 12 months or more may elapse before figures forecast for the December budget are used to measure actual performance. Many things may happen during this intervening period and they may make the figures go widely out of line with the actual figures. Though it is true that a fixed, or static budget as it is sometimes called can be revise whenever the necessity arises, it smacks of of rigidity and artificially so far as control over costs and expenses are concerned.

Flexible Budget:-

Flexible Budget or Variable Budget is one which provides estimates for different levels of activities. It is a budget which by recognising the difference in behaviour between fixed and variable costs in relation to fluctuations in output or turnover, is designed to change appropriately with such fluctuations. A flexible budget may, for example, provide estimates for 50%, 60%, 70% and 80% production capacities. The actual production can be compared with the appropriate estimate in the budget

Need for flexible Budget:

A flexible Budget is a Budget designed to change in accordance with the level of activity actually attained. It is also known as variable or sliding scale budget. It is prepared in such a way as to present the budgeted cost for different levels of activity. It is more realistic and practical in that the changes expected at various levels of activity are given due weightage. Flexible Budgeting is

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desirable in the following cases

(i) where sales are not predictable and certain because of the peculiar nature of the business

Eg:- Business dealing in luxury or semi-luxury goods

(ii) where the venture is a new one and accurate demand forecasting is a tedious task, particularly when there is a question of specific customers' tastes and fashions

(iii) where the business is subject to the vagaries of nature such as soft drinks etc

(iv) where the production cannot be estimated because of uncertainities as regards availability of materials or labour

Features of Flexible Budget:

(1) They are prepared for a range of activity instead of a single level

(2) They provide a sound basis for comparison because they are automatically geared to changes in volume

(3) They provide a ready-made budget for a particular volume.

(4) These are based upon adequate knowledge of cost behaviour pattern.

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Components:-

The main master Budget components are the operating Budget and the financial Budget

Operating Budget:-

It is related to the firm's operating activities and includes the revenues generated and expenses incurred. This is presented in the form of the budgeted income statement representing the income generating activities carried on within an organization

Financial Budget:-

It shows information about the financial position of the firm. It also represents the cash budget, which gives information about cash availability. The financial Budget is prepared by making a budgeted Balancesheet that uses the operating budget information

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Example :-

when a company undergoes the merger and acquisition process, then the master budget is prepared to see what the company gains from the transaction of acquiring the target company. For instance every company has an HR and Admin department. Therefore, when a company is acquired, this would result in 2 staff members in the same category

Here, the company has to make the budget to decide who to keep and who to let go of for the betterment of the business. Thus, the management must prepare this budget before making any expansion plans. Thus, the master budget has detailed information about the future financial statements and cashflows estimated after considering current loan rates, cash flows and debt limits

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