BUDGET AND BUDGETARY CONTROL

A business concern has to utilize its resources effectively in order to achieve its main objective of maximizing profit. Profit maximization depends on planning and control of its activities. Various managerial tools, techniques and procedures are often used by the management in managing the business successfully. Budgeting and budgetary control are the tools in the hands of management for effective utilization of resources.

Budget - Meaning and Definition

A budget is a written plan covering projected activities of a business for a definite future period of time. It is a financial and/or quantitative expression of business plans and policies to be pursued in the future period of time. A budget is prepared to have effective utilization of funds and for the realization of objectives as efficiently as possible. Budgeting is used for preparing budgets and other procedures for planning, co-ordination and control of business enterprise.

Budgetary Control - Meaning and Definitions

Budgetary control is the process of determining various budgeted figures and comparing them with the actual performance for calculating variances, if any Comparison of budgeted and actual figures will enable the management to find out discrepancies and take remedial measures at proper time.

J. Batty defines budgetary control as *"A system which uses budgets as a means of planning and controlling all aspects of producing and/or selling commodities and providing services."*

Characteristics of good budget, budgeting and budgetary control

1. Setting up of objectives: Before preparing the budget, the organisational goals are to be fixed. On the basis of organisational goals, budgets are formulated and implemented.
2. Preparation in advance: A budget is a statement prepared in advance for a definite future period. It is formulated in advance on future plan of actions.
3. Financial and/or quantitative statement: A budget is a special form of statement in which management plans are numerically expressed in financial / physical units.
4. Participation of all: A good budgeting system should involve persons at all levels of management. Active participation of all executives and subordinates is very essential for the preparation and implementation of budgets.
5. One budget for each department: The head of each department prepares a budget for that department and the same is sent to the budget committee.
6. Fixing Authority and Responsibility: In order to achieve the objectives of the management, there should be a well-planned organisational set-up with clearly demarcated authority and responsibility.

7. Co-ordination: In order to achieve the objectives of the organisation, the budgeting system should co-ordinate the plans and activities of various departments.

8. Proper reporting system: A proper reporting system should be present, so that, the actual results could be compared with the budgets.

9. Budget revision: A budget should be realistic. If it is not attainable or if it is not realistic, it should be revised with maximum care, so that, it becomes realistic.

Objectives / Purpose / Need for budget / budgeting and budgetary control

1. **To formulate a plan of action**: Budget helps to formulate a plan of action. The plan of action depends upon the policy that the business decides to execute.

2. **To provide a means of co-ordination**: All the activities of the business are to be coordinated to achieve the objectives. Although different budgets are prepared for different activities, co-ordination between them is made by preparing a summary budget called master budget.

3. **To facilitate central control**: Budget is a means for the top management to control the business operation centrally. For the proper implementation of the policy and achieving targets,

there should be central control and delegation of authority and responsibility to the executives.

4. **To help in cost control**: The main objective of the budget is cost control. Cost control is the process of controlling the costs by eliminating wastage. Preparation of budgets help in the control of cost through comparison.

5. **To help in cost reduction**: Cost reduction is the achievement of real and permanent reduction in the cost of goods manufactured or services rendered without affecting their quality. Budgeting system helps to reduce the cost of the products or services.

6. **Fixation of responsibility of executives**: By preparing an organisation chart, the responsibilities and authorities of executives are fixed.

7. **Fixing for performance**: Budgeting system provides adequate and satisfactory norms of performance over the various activities of the enterprise.

8. **Proper utilization of resources**: Budgeting and budgetary control helps to use the assets and resources of the enterprise most efficiently and effectively.

9. **To motivate the employees**: Budget creates a feeling in employees that the management is taking interest in budget performance for

the success of the enterprise. It may motivate them to achieve the objectives.

Essentials of Budgetary Control

The programme of effective budgetary control should possess the following essentials.

i. **A clearly defined organisation**: There should be a sound plan of organisation with well-defined responsibilities.

ii. **A well-defined policy**: The policies of the management should be well defined in clear and unambiguous terms.

iii. **Proper Delegation of Authority and Responsibility**: Budget preparation and control is done at every level of management. Though the budgets are finalized at top level, involvement of persons from lower levels of management is essential for their success. This requires proper delegation of authority and responsibility.

iv. **Effective Communication System**: An effective communication system is required for a successful budgetary control. The flow of information regarding budgets should be quick so that these are properly implemented.

v. **Budget Education**: Everyone in the organisation should know the working of the budget programme and its benefits. They should be educated about their role in the success of the system.

vi. **Logical sequence in budget preparation**: It is essential that proper arrangements be made for the preparation, submission, examination and review of budget in logical sequence.

vii. **Participation of all employees**: Budgeting requires active participation and involvement of all employees in the organisation. It is meant for every segment of the business. In addition to their active participation, the employees should give more practical and useful suggestions.

viii. **Flexibility:** Budgetary programme should be designed to accommodate unforeseen Circumstances as well as possible changes in future. Flexibility will make the budgets more appropriate and realistic.

ix. **Motivation:** Successful implementation of budget depends upon the interest shown by the employees in the organisation. A proper system of motivation should be introduced for m9king it a success.

Step in the preparation of Budget

For the preparation and successful implementation of budget, the following organisational systems are to be ensured:

1. Appointment of Budget Controller or Budget Officer

A Budget Controller or Budget Director or Budget Officer is a person appointed by the Chief Executive of the organisation for the purpose of assisting the Chief Executive or the President of the organisation in the preparation and effective implementation of budget. The budget controller should have knowledge of the technical details of the business and should report directly to the President or Chief Executive Officer of the organisation.

2. Formulation of Budget Committee

A Budget Committee is a permanent committee consisting heads of all functional departments such as sales department, production department, finance department, human resources department, etc. as members and usually the Chief Executive Officer (CEO) or President or Managing Director as its Chairman. The budget committee has to assists the Budget Controller in all the stages of budgeting. The committee makes the budgeting system more effective. It is the budget committee which receives the budget from each department, co-ordinates the budgets of different departments and reviews and finalizes the budgets.

Functions of Budget Committee / Budget Controller

1. Providing historical data: In order to prepare budgets, the functional departments require historical data. The budget committee is responsible for providing the required data to different departments.
2. Helping the preparation of budget: The budget committee is entrusted with the duty of helping the different departments in the preparation of functional budgets
3. Preparation of programme for budgeting: A general programme for budgeting should be prepared by the budget committee. The programme should give an overall view of the budget schedules.
4. Co-ordinating the departmental budgets: It is the budget committee which has to co-ordinate departmental budgets resolving any conflict between them.
5. Preparation of master budget: With the help of the functional budgets prepared by different functional heads, the budget committee has to prepare a summary budget known as master budget.

6. Comparing the budget with actual: The budget committee has to compare the budgeted figures with the actual performance, so that, the variations may be ascertained and analyzed.

7. Revising the budget: If the budget is found unrealistic, the committee has to revise the budget, if conditions so warrant.

3. Fixation of Budget Period

A budget period is the length of time for which a budget is prepared and employed. The length of period depends on the nature of the business, the control aspect, production period, availability of finance, length of trade cycle, etc.

Industries with huge capital expenditure require **long-term budgeting**, whereas, seasonal industries may adopt **short-term budgets.**

4. Identification of Budget Centers

Budget centers are departments or centers established for budgeting and budgetary control. Budget centers are established for cost control and cost reduction and all budgets are related to cost centers. Separate budget may be prepared for each budget center and the person in charge of the budget center may be made responsible for carrying out the budget.

A budget center is defined as "*a department or section of the organisation defined for the purpose of budgetary control*.”

5. Identification of Budget Key Factor

Industry	Key factor
1. Car manufacturing	Sales demand
2. Petroleum refinery	Availability of crude oil
3. Aluminium industry	Power supply
4. Hydroelectric power generation	Rain water
5. Handicraft	Skilled workers

A Key Factor or Governing Factor or Limiting Factor is the factor which affects or limits the entire activities of an organisation. It is a factor whose influence affects all other budgets. Therefore, budget estimate of key factor is prepared before other budgets are framed. The key factor may be the shortage of raw-materials or labour, limited plant capacity or sales, government restrictions, etc. The key factor highlights the limitations of the enterprise. This will enable the management to improve the working of those departments where scope for improvement exists.

The ICMA London defines it as "the factor, the extent of whose influence must first be assessed in order to ensure that the functional budgets are reasonably capable of fulfillment."

List of key factors

6. Preparation of Budget Manual

A budget manual is a document or schedule prepared by the Budget Controller showing the budgeting organisation, budget programmes and procedures. It fixes the responsibilities of different executives entrusted with the function of implementing the budget. It covers in detail all aspects of budgeting and its administration.

ICMA London defines Budget Manual as *"A document which sets out the responsibilities of the persons engaged in the routine work and the forms and records required for budgetary control."*

Budget manual is a document which contains the following information:

1. A brief outline of the budgeting system and its objectives.
2. The process to be followed in its operation.
3. Setting out the responsibilities of various executives and persons involved in its preparation.
4. The important factors that must be considered for each forecast and plan.
5. Length of the budget period, date of preparation of budget estimates and dates of review, revision and instructions issued.
6. Method of accounting to be adopted.
7. Procedure for preparation of financial statements and the procedure for reporting.
8. Sanctioning authorities of the various budgets and the financial powers of the different managers.

7. Setting up of Organisation chart

It is essential that a concern must have a definite plan of organisation for preparing, maintaining and administering a budget. All the functional heads such as sales manager, production manager, finance manager, etc. are entrusted with the responsibility of ensuring proper implementation of their respective departmental budgets. For the purpose, a chart known as organisation chart is prepared.

An Organisation Chart is a chart prepared for the effective implementation of the budgetary control system by fixing authority and responsibility to each executive for effective implementation of the budget.

Preparation of Master Budget

Master Budget or Summary Budget is a summary of the budget schedules in capsule form, made for the purpose of presenting in one report, the highlights of the budget forecast. A master budget is prepared for the business as a whole, combining all the budgets of the period.

The Institute of Cost and Management Accounts (ICMA), London defines it as "the summary' budget, incorporating its component functional budgets, which is finally approved, adopted and employed."

Benefits of Master Budget

i. Co-ordinating the functional budgets: The master budget helps to co-ordinate all the functional budgets in a summarized form.

ii. Acts as a basis of budgeted Profit and Loss Account and Balance Sheet: Master budget being a consolidated summary of the various functional budgets, it serves as the basis upon which budgeted Profit and Loss account and projected Balance Sheet are constructed.

iii. Checking the accuracy of functional budgets: Master budget helps to check the accuracy of all the functional budgets as it is a summary of various functional budgets.

Functional Budgets

Functional budgets are those budgets which relate to the functions of different departments in an organisation. The number of these budgets depends on the size and nature of business. The commonly used functional budgets are Sales Budget, Production Budget, Material Budget, Manufacturing Overheads Budget, Administration Cost Budget, Selling and Distribution Cost Budget, Plant Utilization Budget, Capital Expenditure Budget, Research and Development Cost Budget, Cash or Financial Budget, etc.

i. Sales Budget

A Sales budget is a functional budget prepared by the sales department showing the quantities and values of expected sale of finished products in total as well as product-wise and area-wise during a definite period of time. Sales budget serves as a basis for the preparation of production budget and other budgets. In its preparation, the sales manager has to consider the sales of the previous year, general trade conditions, availability of funds, seasonal fluctuations, restrictions imposed by the government, competition and consumers' preference, efficiency of advertising, etc.

ii. Production Budget

Production Budget is a budget prepared by the production department, showing the physical quantities of the products to be produced during the budget period. Apart from the sales budget, opening stock and closing stock of finished goods, optimum utilization of plant capacity, inventory policy, production policy, normal wastage in production, etc. are considered while preparing production budget. Production budget serves as a basis for the preparation of cost budget.

iii. **Direct Material Purchase Budget**

To carry out production satisfactorily, regular supply of materials has to be ensured. For the purpose, a direct material purchase budget is prepared. *Direct material purchase budget is the budget prepared by the Purchase Manager or Purchase Director showing the physical quantities and cost of materials to be purchased during the* *budget period.* The direct material purchase provides answers to the questions like:

i. What is to be purchased? ii. When is to be purchased? And iii. Where is to be purchased?

iv. Direct Labour Cost Budget

Direct labour cost budget is the budget prepared by Personnel Manager or Director showing the hours and cost of total labour force required during the budget period. Production requirement, quality standard of each type of labour, standard rate of each type of labour, efficiency of labour, etc. are the factors to be considered while preparing direct labour cost budget.

v. Manufacturing Overhead Budget

This budget gives an estimate of the works overhead expenses to be incurred in a budget period to achieve the production target. The budget includes the cost of indirect materials, indirect labour and indirect works expenses. The budget cost may be classified in to fixed cost, variable cost and semi variable cost. Usually the budget is prepared by the Production Manager/Director or Cost Accountant.

vi. Administrative Cost Budget

This budget covers the expenses incurred in framing policies, directing the organisation and controlling the business operations.

The budget can be prepared with the help of past experience and anticipated changes. Budget may be prepared separately for each administration department. The Administration Director/Manager is directly responsible for the preparation and execution of overall office and administrative cost budget.

vii. **Selling and Distribution Cost Budget**

Selling and Distribution Cost Budget represents the amount of total selling and distribution cost to be incurred during budget period. This budget is clearly related to the sales budget. All expenses relating to selling and distribution of various products are included in it. These expenses are based on the volume of sales set in the sales budget and budgets are prepared for each item of selling and distribution overhead. Selling and distribution overheads are divided into fixed and variable categories with reference to volume of sales. The Sales Manager/Director is directly responsible for the preparation and execution of overall selling and distribution cost budget.

viii. **Capital Expenditure Budget**

This budget gives an estimate of the amount of capital that may be needed to acquiring the fixed assets required for fulfilling production requirements as specified in the production budget. This budget is prepared after taking in to consideration the available productive capacities, probable reallocation of existing assets and possible improvement in production techniques.

ix. Research and Development Cost Budget

Research cost represents the cost of searching for new or improved productio^{n} techniques, new application of materials or improved methods, processes, system or services.

Development cost refers to the commercial application of knowledge gained from research. It begins with the implementation of the decision to produce new or improved products and ends with the commencement of formal production of that product.

Research and development cost budget represents the amount of total research and development cost to be incurred during budget period.

X. Cash (Financial) Budget

Cash budget is a statement prepared in advance showing the estimated cash receipts and cash disbursements during a specific future period of time. It shows the estimated cash inflows, estimated cash outflows and deficit or surplus over a given budget period.

A cash budget is defined *as "an analysis of flow of cash in a business over a future, shod or long period of time. It is a forecast of expected cash inflow and outflow. "*

Need/Importance/Purpose/Advantage of preparing Cash Budget

i. **Ensuring liquidity**: Cash budget ensures that cash is available in time for carrying out business activities and meeting financial obligation.

ii. **Maintenance of working capital**: A properly designed cash budget helps to maintain working capital position safe by making financial arrangements in advance to overcome shortage of funds.

iii. **Best utilization of fund**: A properly drawn cash budget helps the management to use any surplus fund available in the best possible manner.

iv. **Capital investment:** A cash budget enables the management to plan for financing expansion, modernization of existing plant, financing new projects, etc.

v. **Preparing borrowing schedule**: There may be certain seasons when there is shortage of funds for storing materials. Cash budget enables management to prepare borrowing schedule.

vi. **Preparing repayment schedule**: Payments to creditors and others have to made as per schedule. Cash budget helps management to prepare repayment schedule well in advance.

vii Planning dividend payment: A well designed cash budget enables the management to plan for dividend payment well in advance.

Methods of Preparing Cash Budgets

There are three methods of preparing cash forecasts:

A. Receipts and payments method

B. Balance Sheet forecast method and

C. Profit forecast method.

*A.*RECEIPTS AND PAYMENTS METHOD

This method is applicable for short-term budgeting. Forecasts of cash receipts and payments are made on the basis of functional budgets including capital expenditure and research and development budgets.

Under this method, all the probable receipts are added to the opening balance of cash and the probable payments of the period are deducted, thus forecasting a balance of cash at the end of the period. A format cash forecast based on this method is given below:

Cash budget for the months from April to June

	APRIL	MAY	JUNE
Opening Balance/Balance b/d			
Add receipts			
Cash sales	xxx	xxx	xxx
Trade debtors	xxx	xxx	xxx
Loans, sale of assets, Other receipts	xxx	xxx	xxx
Total	xxx	xxx	xxx
Payments : -			
Cash purchases	xxx	xxx	xxx
Trade creditors	xxx	xxx	xxx
Wages,salaries,Expenses,othe payments	xxx	xxx	xxx
Total	xxx	xxxx	xxx
Closing balance/ Balance c/d	xxx	xxx	xxx

B.BALANCE SHEET FORECAST METHOD:

This method is used for long term or annual forecasts. Under this method, all anticipated changes in the Balance Sheet items are either added to the opening balance of cash or deducted from it as shown below:

Opening Balance of Cash		xxxx
Add: Reduction in assets	xxx	
Increase in liabilities	xxx	xxxx
		xxxx
Less: Increase in assets	xxx	
Reduction in liabilities	xxx	xxxx
Closing Cash Balance		xxxx

C.PROFIT FORECAST METHOD

This method is also useful for long-term forecast of cash and is based on the assumption that cash balance would increase by the amount of profit. For the purpose, the amount of net profit and the non-cash items of expenses like depreciation, provisions and reserves, accrued expenses, etc. are added and the items like dividends, capital payments, increase in stock and debtors etc. are deducted to arrive at closing cash balance.

Fixed Budget

A fixed budget or static budget is a budget which remains unchanged irrespective Of the actual volume of output or level of activity achieved. This budget is drawn for one level of activity and one set of condition on the assumption that the forecast of the business activity will prove correct. Fixed budget is inoperative and ineffective as it does give due consideration to cost behavior at different levels of activities.

ICMA London defines a fixed budget *as "a budget designed to remain unchanged irrespective of the level of activity actually attained. "*

Flexible Budget

Flexible budgets are a series of budgets prepared for different levels of activity or .volume o foutput. It is also known as 'Variable Budget' or 'Sliding Scale Budget.

ICMA, London defines it as "a budget designed to change in accordance with the level of activity actually attained. "

Features of Flexible Budget

1. It is prepared for different levels of activity.
2. It changes with the change in the level of activity.
3. Expenses are classified in to fixed, variable and semi variable. Semi variable expenses are further segregated into fixed and variable expenses.

Advantages of Budgetary Control

1. **Helps to formulate plans of action**: Budget sets out plans of actions and targets to be achieved by the departments as well as individuals. Therefore, everyone knows for what he is responsible and how much he should do for it for which a team spirit will be developed.

2. **Helps to provide means of co-ordination**: All the activities of the business are to be coordinated to achieve the objectives of budgeting. Preparation of summary budget helps to coordinate the activities of different departments.

3. **Helps in central control**: Budget is a means for the top management to control the business operation centrally. For the proper implementation of the policy and achieving the target, there is a need for delegation of authority and responsibility of executives.

4. **Helps in cost control**: Cost control is the process of controlling the costs by eliminating wastage. Preparation of budget helps in the control of cost through comparison.

5. **Helps in cost reduction**: Cost reduction is the achievement of real and permanent reduction in the cost of goods manufactured or services rendered without affecting their quality. Budgeting helps to reduce the cost of the products or services.

6. **Helps in responsibility of executives**: By preparing a chart known as organization chart, the responsibilities and authorities of executives are fixed.

7. **Helps in fixing norms for performance**: Budgeting system provides adequate and satisfactory norms for performances over the various activities of the enterprise.

8. **Helps in proper utilisation of resource** : Budgeting and budgetary control helps to use the assets and resources of the enterprise most efficiently and effectively.

9. **Helps in motivating the employees:** get creates a feeling in employees that the management is taking interest in budget performance for the success of the enterprise. It may motivate them to achieve the objectives.

10. **Helps in improving efficiency**: Budgetary control promotes efficiency and economy by creating cost consciousness among employees.

11. **Helps to pin-point discrepancies**: Budgetary control reveals whether things are moving in right direction or not, by pi pointing deviation of actual results from budgets.

12. **Helps to introduce incentive system wage payment**: Budgetary control acts as an internal audit system through continuous scrutiny of departmental results. It helps in the introduction of incentive remuneration system based on performance.

Disadvantages of Budgetary Control

1.Estimates are likely to go wrong: Budgets are prepared for the future period. Despite the best estimate made for future, the predictions may not always come true. Future may be uncertain and the situation which is presumed to prevail in future may change, upsetting the entire budget.

2.**Efficient workers are likely to become lazy**: More efficient persons become less efficient in the target fixed in the budget is low. As one has to achieve only the target fixed, persons who can surpass the target will be contented with achieving the target.

3. **Budgets are made on some assumptions**: Budgets are prepared on the assumption that certain conditions will prevail during the budget period. But, the may fail to remain.

4. **Frequent revision of budget**: Future being uncertain and the assumed conditions may not prevail, frequent revision of budget become essential.

5. Chance of conflict among executives: Budgetary control may lead to conflict among the different functional departments as each departmental head is concerned only about the goals to be achieved by his department. Every department try to get maximum allocation of funds which may lead to conflict among different departments.

6. Dependence on support of top management: Success of budgeting depends on the support of top management. If there is lack of support from top management, the system will collapse.

7. Lack of co-operation from staff: Budgetary control system often fails to get support and co-operation from staff.

8. Rigidity in operation: Budgets are considered as rigid documents. It lacks flexibility

Zero Base Budgeting

Zero Base Budgeting (ZBB) as a new managerial tool has become increasingly popular since 1962. It was first introduced by Ex-president Jimmy Carter of America, the then Governor of the State of Georgia as a means of controlling State expenditure. It has gained acceptance in the management field as it integrates the managerial functions of planning and control.

Meaning and Definition

Zero Base Budgeting refers to a system of budgeting which is **not based on any historical data**, but is developed on the basis of likely activities of the future period. Since the budgeting is based on zero or scratch, it is known as zero based budgeting. In zero base budgeting, an executive has to justify the amount he wants to spend. Preference of spending on various activities depend upon their justification. For sanctioning certain amount, the executive has to convince that the activities are essential and the amount requested is reasonable.

Performance Budgeting

Performance budgeting is developed as a means of controlling and improving the Performance of budget centers or responsibility centers. It helps to evaluate the Performance of each center as well as the organization by setting up target and comparing the performance.

Meaning and Definition

Performance budgeting is a technique under which responsibility centers are established and the targets in terms of physical performance are set for each responsibility center which helps to evaluate of the performance of the responsibility centers and the organization as a whole. It pre-supposes the crystal clarity of organizational objectives in general and short-term business objectives as stipulated in the budget, in particular. It provides a definite direction to each employee and also a control mechanism to higher management.

Activity Based Budgeting (ABB)

Activity Based Budgeting (ABB) is also called as Activity Based Cost Management (ABCM). This method of budgeting helps to prepare indirect cost budgets more scientifically on the basis of level of activity rather than on guesswork. This is very important in me changing scenario where indirect cost out ways the direct processing cost in many situations .This is different from the traditional method of making budgets where previous year’s figures are taken as base to which certain additions are made for increase in cost for the next year.

Rolling/Continuous Budgets

CMA Official Terminology defines a rolling budget as "budget continuously updated by adding a further period, say a month or quarter, and deducing the earlier period". The need for preparing a rolling budget arise due to the element of uncertainty in budgeting mainly of price level changes. Rolling budgets, also known as continuous budgets, are prepared for a short-term as the degree of uncertainty is much lower and these budgets are continuously modified for the next period, keeping in view of the changes that might have taken place. Thus, control becomes more effective with the use of rolling budget as it is based upon recent plans. However, it involves more time, effort and money in preparation of rolling budgets.

Programme Budgeting

Programme Budgeting, also known as Planning, Programming and Budgeting System (PPBS) is a budgetary project that is aimed at making government operations more efficient and more effective. PPBS was first introduced in the U.S. department of defence in 1961. The purpose of programme budgeting is to reform the assignments of funds within the public sector and to improve the allocation of funds between the private and public sectors. In PPB system, expenditure is classified according to the objectives rather than functions.