UNIT 8 BASIC CONCEPTS OF BUDGETING

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8.0 OBJECTIVES

The main objectives of this unit are to acquaint you with:

- the concepts of budgeting and budgetary control;
- the establishment of effective budgeting system; and
- classification of various types of budget.

8.1 INTRODUCTION

The efficiency of a management depends upon the attainment of the objectives of the enterprise. It is effective when it achieves the objectives with minimum effort and cost. This requires proper planning and therefore, management must chart out its course of action in advance. One systematic approach for attaining effective management performance is profit planning and control or budgeting. Profit planning or budgeting is an integral part of management. Budgeting is an important control technique of cost control. This is the process of pre-estimation of cost, revenue, profit and other figures for the next year or period and on that basis, actual expenses incurred, revenue generated/earned. Afterwards budget is used as a standard for measuring actual performance. The deviations are found out and responsibility fixed for deviations. Thus, this is indirectly management control process, which involves planning, control, coordination, communication, etc. In this unit you will study about the basic concept of budgeting, establishment of a system of budgeting and classification of budgets.

8.2 MEANING OF BUDGETING

In our daily life, we use to prepare budgets for matching the expenses with income; and available funds can be invested in a profitable manner. Similarly in business, budgets are prepared on the basis of future estimated production and sales in order to find out the profit in a specified period. A budget is in the nature of an estimate and is a quantified plan for future activities to coordinate and control the use of resources for a specified period. Thus budget is a quantitative statement of management plans and policies for a given period and is used as a guide for the purpose of attaining the given objectives. It is also used as standard with which actual performance is measured. Budgets must be prepared with full knowledge and acceptance by the executives whose performance is to be measured against the budget. Different types of budgets are prepared for different purposes.

Budgeting may be defined as the process of preparing plans for future activities of a business enterprise after considering and involving the objectives of the said organization. This also provides process/steps of collection and comparison of data, by which deviations from the plan, either favourable or adverse, can be measured. This analysis is helpful in performance analysis, cost estimation, minimizing wastage and better utilisation of resources of the organisation.

8.3 DEFINITION OF BUDGET AND BUDGETARY CONTROL

Budgeting is a process, which includes two important functions: Budget and Budgetary control. Budget is a planning function and budgetary control is a controlling system or technique. A manager looks to the future, searches for alternative courses of action and predetermines a course of action to be taken in relation to known events and the possibilities of future problems. Thus, the budget will do this work for the activities of a business enterprise. I.C.M.A., London defines the budget as "Budget is financial and/or quantitative statement, prepared prior to a defined period of time, of the policy to be pursued during that period for the purpose of attaining a given object".

At the same time, controlling is the process of measuring current performances and guiding them towards some predetermined goals. The essence of control lies in checking existing actions against some desired results determined in the planning process. Thus, the budgetary control is a tool of control to achieve the budgeted goals. I.C.M.A., London defines budgetary control as, "Budgetary control is the establishment of budgets relating to the responsibilities of executives to the requirement of a policy and the continuous comparison of actual with budgeted results either to secure by individual action the objectives of that policy or to provide a basis for its revision."

In nutshell, Budgetary control is a system and a technique which uses budgets as a means of controlling all aspects of the business and is designed to assist management in the allocation of responsibility and authority, in the measurement of actual performance, in the analysis of variations between budgeted and actual results and to develop basis of measurement, in the light of experience gained and results achieved, with which to evaluate performance and efficiency of the operations. Thus, a budget is a means and budgetary control is the end result.

8.4 OBJECTIVES OF BUDGETING

It is a well known fact that a planned activity has better chances of success than an unplanned one. The budgeting is a forward planning and effective control tool. Thus, the objectives of the budgeting are:

a) To control the cost and increase revenue and thereby maximise profit, so as to know profit at different level of production and best production level.

b) To run production activities in efficient manner by lay behind the chances of interruption in production process due to lack of material, labour etc.

c) To bring about coordination between different functions of an enterprise, which is essential for the success of any enterprise.

d) To incorporate measures of calculation of deviations from budgeted results and analysis of the same, whereby responsibility can be fixed and controlling measures/action can be taken.

e) To ensure that actions taken are in accordance with the targets and if required, to take suitable corrective action.

f) To predict short-term and long-term financial positions for better financial position and management of working capital in better manner.

8.5 ADVANTAGES OF BUDGETING

The following are the advantages of budgeting:

a) Budgeting leads to maximum utilisation of resources with a view to ensuring maximum return.

b) Budgeting increases the awareness about business enterprise at all levels of management in the process of fulfillment of targets.

c) Budgeting is helpful in better co-ordination between different functions/activities of business/organisation and hence, better understanding between different functions.

d) Budgeting is a process of self-examination and self-criticism which is essential for the success of any organisation.

e) Budgeting makes a path for active participation and support of top management

f) Budgeting enables the organisation to prefix its goals and push up the forces towards their achievements.

g) Budgeting stimulates the effective use of resources and creates an attitude of cost consciousness throughout the organisation.

h) It creates the bases for measuring performances of different departments as well as different functions of the production activities.

8.6 LIMITATIONS OF BUDGETING

Inspite of the above advantages, budgeting has the following limitations:

a) Forecasting, planning or budgeting is not an exact science and a certain amount of judgement is present in any budgeting plan.

b) The basic requirement for the success of budgeting is the absolute support and enthusian provided by the top management. If it is lacking at any time, the whole system will collapse.

c) Budgeting should be followed up by effective control action, this is often lacking in many organisations, which defeats the very purpose of budgeting.

d) The installation of budgeting system is an elaborate process and it takes time.

e) It is only a source and not a target and hence, can not take the place of management, while it is only a tool of management. Thus, the budget should be regarded not as a master, but as a servant.

f) It requires the experienced man-power, technical staff, analysis, control etc, hence, it is costly affair.

8.7 ESSENTIALS OF EFFECTIVE BUDGETING

A good budgeting system requires good organisational system with lines of authority and responsibility clearly mentioned. There must be perfect co-ordination among different functions as well as participation of responsible managers / supervisors in the decision making process. Thus, the main essentials of effective budgeting may be as follows:

a) There should be well-planned organisational set-up, authority and responsibility clearly defined, budget committee should be formed consisting of all top executives.

b) There should be a good accounting system which provides accurate and timely information.

c) Variations should be reported promptly and clearly to the appropriate levels of management.

d) Budgets have no meaning unless they lead to control action as a consequence of feedback provided.

e) The whole system should enjoy the support and co-operation of top management.

f) Staff should be strongly and properly motivated towards the systems.

g) Budgets should be prepared on the basis of clearly defined business policies after discussion held with the head of individual department so that they may provide their suggestions in this regard.

8.8 ESTABLISHING A BUDGETING SYSTEM

For preparing an efficient budget, there is an urgent need of well-versed system for preparing the budget. This process is required an efficient system of implementation within the organisation. The main essentials of establishment of system of budgeting are:

1) Budget Centres

2) Budget Committee

3) Budget Officer

4) Budget Manual

5) Budget Period

6) Budget Key Factor or Determining Principal Budget Factor

7) Forecasting

8) Determining Level of Activity

9) Preparation of Budget

Let us study each one of the above in detail.

1) **Budget Centres:** Budget centre are defined as different sections of an undertaking or an organisation, where budgetary control measures are to be applied and for the purpose, separate budgets are to be prepared with the help of head of these centres so that these may be implemented more efficiently.

2) **Budget Committee:** The budget committee is a group of representatives of various functions in an organisation, *e.g.* Sales Manager, Production Manager, R&D Manager, Materials Manager, etc. As all functions are interrelated and any change in one's target will have its impact on that of the others. Therefore, it is necessary to discuss the targets so that a mutually agreed programme can be determined. This is really the co-ordination in budget making. It is powerful force in knitting together the various activities of the business and enforcing real control over operations. The principle functions of a Budget Committee are:

a) To provide departmental managers past data regarding performance, costs etc. thus, helping them to prepare their respective budgets.

b) To co-ordinate, receive, review the functional budgets in the light of general policies and objective of the organisation.

c) To approve the functional budgets after making necessary changes.

d) To prepare and present the Master Budget on the basis of functional budgets, so developed and approved for final considerations and approval of the Board of Directors.

e) To recommend action to be taken on the basis of variance analysis.

3) **Budget Officer:** To link up or co-ordinate the various functions, to bring them together and to co-ordinate their efforts in the matter of preparation of target figures, there should be a person called Budget Officer or Budget Controller. He is enable to provide ready data relating to all the functions. He is more or less the Secretary to the Budget Committee. His duties will comprise mainly:

a) Helping in preparation of the various budgets and their co-ordinations and compilation into the master budget.

b) Compiling information about actual performance on a continuous basis, comparing it against the budget figures, ascertaining causes of deviation and preparing reports based thereon and sending them to the appropriate executives.

c) Bringing to the notice of the management the need for revision of budgets and assisting them in the task, and

d) Compiling information of all types for the purpose of efficient preparation of budgets and proper reporting.

4) **Budget Manual:** Budget manual is defined as a document which sets outstanding instructions, the responsibility of the persons engaged in, and the procedures, forms and records relating to the preparation and use of budgets. Thus budget manual is a booklet of budget policies which lays down the details of the organisational set up with duties and responsibilities of executives including the budget committee and budget officer and procedures to be followed for developing budget in respect of various activities.

The following are some of the important matters dealt with in the budget manual:

a) The dates by which preliminary forecasts and plans are to be submitted.

b) The forms in which these are to be submitted and the person to whom these are to be forwarded.

c) The important factors that must be considered for each forecast or plan

d) The categorisation of expenses, *e.g.*, variable and fixed, and the manner in which each category is to be estimated and dealt with.

e) The manner of scrutiny and the personnel to carry it out.

f) The matter which must be settled only with the consent of the managing director, departmental manager, etc.

g) The finalisation of the functional budgets and their compilation into the Master Budget.

h) The form in which the various reports are to be made out, their periodicity and dates, the persons to whom these and their copies are to be sent.

i) The reporting of the remedial actions.

j) The manner in which budgets, after acceptance and issuance, are to be revised or amended, and

k) The matters to be included in budgets, on which action may be taken only with the approval of top management.

5) **Budget Period:** This is the period for which forecasts can reasonably be made and budgets can be formulated. Budget periods vary between short-term and long-term and no specific period can be laid down for all budgets. Normally, a detailed budget for each responsibility centre is prepared for one year. In fact, the length of the budget period depends on the type of the business, the length of the manufacturing cycle from raw material to finished products, the ease or difficulty of forecasting future market conditions and other factors. It should be kept in mind that the budget period should be long enough to allow for the financing of production well in advance of actual needs and also coincide with the financial accounting period to compare actual results with budgeted estimates.

6) **Budget Key Factor or Determining Principal Budget Factor:** The key factor is also known as limiting factor, governing factor, etc. and may be defined as the factor which at a particular time or over a period will limit the activities of an undertaking. The limiting factor is, usually, the level of demand for the products or services of the undertaking, but it could be a shortage of one of the productive resources, *e.g.* skilled labour, raw material, or machine capacity etc.. In order to ensure that the functional budgets are reasonably capable of fulfillment, the extent of the influence of this factor must be assessed.

The key factor is normally temporary in nature and is a constraint at a particular point of time. In the long run, they can be overcome by proper planning and management action.

The principal budget factor which will influence the targets may be : (i) customer demand, (ii) plant capacity, (iii) availability of raw materials, (iv) availability of skilled labour, (v) availability of adequate capital, (vi) storage capacity of raw material and finished goods, (vii) space for plant installation, and (viii) governmental restrictions etc.

7) **Forecasting:** Forecasting is the statement of events likely to occur. It connotes a degree of looseness, so that it is usually the practice to judge the accuracy of forecasts on the basis of actual performance, taking the latter to be correct. The forecast of a function need not necessarily be well coordinated. The desired co-ordination could be obtained before the budget is finalised. A forecast forms the basis for the budget. A budget indicates a target and it is a statement of planned events, generally evolved from the forecast.

8) **Determining Level of Activity:** The level of activities are determined on the basis of information and estimates provided regarding / about future conditions and activities of market and position of product in the market by departmental heads or concerned managers. For this purpose, detailed discussions, analysis, preparation of reports are to be done and then written report to be formed and submitted to **budget committee** for their decision making.

9) **Preparation of Budget:** After discussing all the factors, which may affect the process of budgeting, the budget should be prepared. The manager who is responsible for meeting the budgeted performance should prepare the budget for those areas for which they are responsible. The preparation of the budget should be a bottom-up process. This means, the budget should originate at the lowest levels of management and be refined and co-ordinated at higher levels. This will enable managers to participate in the preparation of their budgets and increases the probability that they will accept the budget and strive to achieve the budgeted targets.

When all the budgets prepared by respective managers, then, they should be co-ordinated with each other and corrected in respect of organisational goal and then, summarized into a Master Budget consisting of a Budgeted Profit and Loss Account, a Balance Sheet and a Cash Flow Statement. After the Master Budget has been approved, the budgets are to be passed down through the organisation to the appropriate responsibility centre. The approval of the master budget gives the authority for the manager of each responsibility centre to carry out the plans contained in each budget.

8.9 CLASSIFICATION OF BUDGETS

Budgets can be classified into different categories on the basis of time, functions or flexibility. The different budgets covered under each category are shown in the following chart :

Classification of Budgets

Time
- Long-term
- Short-term
- Current

Function
- Sales
- Production
- Cost of Production
- Purchase
- Personnel
- Research
- Capital Expenditure
- Cash
- Master

Flexibility
- Fixed
- Flexible

Let us study all the above budgets briefly. You will study these budgets in detail in Unit 9.

1) Classification According to Time

The budget, on the basis of time, may be classified as :

a) Long-term budget,

b) Short-term budget, and

c) Current budget.

Long-Term Budget : A budget designed for a long period is termed as a Long-term budget. The period generally is of 5 to 10 years. These budgets are concerned with planning of the operations of a firm over a considerably long period of time. They are generally prepared in terms of physical quantities.

Short-Term Budget : The budget prepared for a period of less than 5 years is a short-term budget. Generally short-term budgets are prepared for a period of one to two years. They are generally prepared in terms of physical as well as in monetary units.

Current Budget : The budget prepared for a period of a week, a month, or a quarter is termed as a current budget. They are essentially short-term budgets adjusted to current conditions or prevailing circumstances.

2) Classification According to Function

Budgets can be classified on the basis of functions, they are meant to perform. Different types of budgets under this head are as follows:

Sales Budget : This is the most important budget on which all other budgets are based. The sales manager is responsible for preparation and execution of the budget. The budget forecasts total sales in terms of quantity, value, items, periods, areas etc.

Production Budget : The budget is basically based on sales budget. It forecasts quantity of production in terms of items, periods, areas, etc. The works manger is responsible for the preparation of overall production budget and departmental works manager is responsible for departmental production budgets.

Cost of Production Budget : It forecasts the cost of production. Separate budgets are prepared for different elements of costs such as direct materials budget, direct labour budget, factory overheads budget, office overheads budget, selling and distribution overhead budget, etc.

Purchase Budget : The budget forecasts the quantity and value of purchases required for production. It gives quantity-wise and period-wise information about the materials to be purchased. It correlates with sales forecast and production planning.

Personnel Budget : The budget anticipates the quantity of personnel required during a period for production activity. This may be further split up between direct and indirect personnel budgets.

Research Budget : The budget relates to the research work to be done for improvement in quality of the products or research for new products.

Capital Expenditure Budget : The budget provides a guidance regarding the amount of capital that may be required for procurement of capital assets during the budget period.

Cash Budgets : The budget is a forecast of the cash position, for a specific duration of time for different time periods. It states the estimated amount of cash receipts and cash payments and the likely balance of cash in hand at the end of different periods.

Master Budget : It is a summary budget incorporating all functional budgets in a capsule form. It interprets different functional budgets and covers within its range the preparation of projected income statement and projected balance sheet.

3) Classification According to Flexibility

Budget can also be classified in the following categories:

Fixed Budget : A budget prepared on the basis of a standard or a fixed level of activity is called a fixed budget. It does not change with the change in the level of activity. If the output and sales do not fluctuate from year to year or if an accurate prediction of the same can be made, a fixed budget can be prepared.

Flexible Budget : A budget designed in a manner so as to give the budgeted cost of any level of activity is termed as a flexible budget. Such a budget is prepared after considering the fixed and variable elements of cost and the changes that may be expected for each item at various levels of operation.

Check Your Progress

1) What do you mean by Budgeting ?

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2) What is Budgetary Control ?

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3) List out the essentials of a sound system of Budgeting.

1 …………………..	4 ………………………………
2 ………………….	5 ……………………………..
3 …………………	6 ……………………………..

4) Differentiate between a Forecast and a Budget.

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5) Fill in the blanks :

a) The process of preparing and using budgets to achieve the objectives of management is called ....

b) .... is a tool of control to achieve the budgeted goals.

c) .... is a group of representatives of various functions of an organisation for preparing budgets and exercising overall control.

d) A book let of budget policies which lays down duties and responsibilities of executives and procedures to be followed for preparation and implementation of budget programme is called ....

e) .... is the basis for preparation of the budget.

f) The most important budget on which all other budgets are based is ....

g) A summary of budget which contains all functional budgets in a capsule form is called ....

h) In the preparation of budgets .... limits the volume of budget activity.

i) A budget may be defined as a .... expression of a business plan for a specified future period.

6) State whether each of the following statements is True or False.

a) A budget is a means and budgetary control is the end result. ( )

b) Budget should be regarded as a master but not as a servant. ( )

c) Key factor can be overcome in the long-run by proper planning. ( )

d) Research budget relates to the improvement in quality and development of the new products. ( )

e) Flexible budget gives details of budgeted cost at any level of activity. ( )

f) A budget is both a plan as well as a control tool. ( )

g) A budget is a base while the forecast is the structure built on the base( )

h) A fixed budget is concerned with budgeting of fixed assets. ( )

i) A budget manual contains a summary of all functional budgets. ( )

j) A budget is a plan of the management for a future period expressed in quantitative terms. ( )

8.10 LET US SUM UP

A budget is in the nature of an estimate and is quantified plan for future activities to coordinate and control the use of resources for a specified period. Budget is used as a standard with which actual performance is measured. Budgeting is a process which includes both budget and budgetory control. Budget is a planning function and budgetory control is a system and technique which uses budgets as a means of controlling all aspects of the business and is designed to assist management in the measurement of actual performance, in the analysis of deviations from the budgeted targets and to evaluate performance and efficiency of the operations. A good budgeting system requires good organisational system with the lines of authority and responsibility clearly mentioned. The important essentials required for the establishment of a sound system of budgeting includes budget centres, budget committee, budget officer, budget manual, budget period, budget key factor, forecasting, determining level of activity and preparation of budget.

Budget may be classified on the basis of time, function and flexibility. On the basis of time, budget may be classified as long term budget, short-term budget and current budget. The classification of budget according to functions generally include : Sales budget, production budget, cost of production budget, purchase budget, personnel budget, research budget, capital expenditure budget, cash budget and master budget. Budget can also be classified according to flexibility as fixed and flexible budget.

8.11 KEY WORDS

Budget : A comprehensive and coordinated plan, expressed in financial terms, for the operations and resources of an enterprise for some specific period in the future.

Budgeting : The process of preparing plans for future activities of a business enterprise for attaining the objectives of an organisation.

Budgetory Control : The establishment of budgets relating to the responsibilities of executives to the requirement of a policy and the continuous comparison of actual with budgeted results either to secure by individual action the objectives of that policy or to provide a basis for its revision.

Budget Centres : Different sections of an undertaking or an organisation, where budgetory control measures to be applied and for the purpose, separate budgets are to be prepared.

Budget Committee : A group of representatives of various functions in an organisation

Budget Officer : A person who links up or coordinates the various functions, to bring them together and coordinate their efforts in the matter of preparation of target figures.

Budget Manual : A document which sets out standing instructions, the responsibility of the persons engaged in, and the procedures, forms and records relating to the preparation and use of budgets.

Budget Period : The period for which forecasts can reasonably be made and budgets can be formulated.

Budget Key Factor : The factor which at a particular time or over a period will limit the activities of an undertaking.

Forecasting : A statement of events likely to occur

Fixed Budget : A budget prepared on the basis of a standard or a fixed level of activity

Flexible Budget : A budget designed in a manner so as to give the budgeted cost at any level of activity.

Master Budget : A summary budget incorporating all functional budgets which is finally approved, adopted and employed.

8.12 ANSWERS TO CHECK YOUR PROGRESS

5) a) Budgeting b) Budgetary control c) Budget Committee
d) Budget Manual e) A forecast f) Sales budget
g) Master budget h) The key factor i) Quantitative

6) a) True, b) False, c) True, d) True, e) False, f) True, g) True, h) False, i) False, j) True

8.13 TERMINAL QUESTIONS

1) Define budgeting and budgetory control. State the objective of Budgeting.
2) What is budgeting ? What are the advantages and limitations of Budgeting ?
3) What are the essentials of an effective system of Budgeting ? Explain
4) What is a Budget Manual ? State briefly the contents of a budget manual.
5) What do you mean by Budgeting ? Mention different types of budgets that a big industrial concern would normally prepare.
6) What are the essentials of establishment of sound system of Budgeting ?
7) Explain the following :
   i) Budget Committee
   ii) Budget Officer
   iii) Budget Key Factor
   iv) Budget Period
8) Explain in brief different types of budgets.
9) "A budget is a means and budgetory control is the end result". Explain.

Note : These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

8.14 FURTHER READINGS

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