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CHAPTER 15 BUDGET

Theory Chart

Chp15 Budget

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BASICS

Introduction

- Budget is a commonly used business language that expresses the business plans in quantifiable terms.
- When the targets are monitored and compared with the actual results with the objective to narrow down the deviations, make participants responsible and implement the preventive and corrective actions, is known as budgetary control.

Budget

- The Chartered Institute of Management Accountants (CIMA), UK defines budget as "A financial and/or quantitative statement, prepared and approved prior to a defined period of time of the policy to be pursued during that period for the purpose of attaining a given objective. It may include income, expenditure and employment of capital"
- The budget is a blue-print of the projected plan of action expressed in quantitative terms for a specified period of time.

Budget vs Forecast

- A forecast is an assessment of probable future events. Budget is a financial/quantitative plan of a business enterprise to be pursued over a period of time.
- Budget is a commitment or a target which the management seeks to attain on the basis of the forecasts made. Forecasts are made regarding sales, production cost and financial requirements of the business.
- Forecast denotes some degree of flexibility while a budget denotes a definite target.

Budgeting

- Budgeting is the process of designing, implementing and operating of budget
- It is a means of coordinating the combined intelligence of an entire organisation into a plan of action based on past performance and governed by rational judgment of factors that will influence the course of business in the future.

ESSENTIAL CHARACTERSTICS OF BUDGET

- It is concerned for a definite future period.
- It is a written document.
- It is a detailed plan of all the economic activities of a business.
- All the departments of a business unit should co-operate for the preparation of a business budget.
- Budget is a means to achieve business objectives and it is not an end in itself.
- Budget needs to be updated, corrected and controlled every time circumstances change. Therefore, it is a continuous process.
- Budget helps in planning, coordination and control.
- Different types of budgets are prepared by industries according to business requirements.
- A budget acts as a business barometer.
- Budget is usually prepared in the light of past experiences.
- Budget is a constant endeavour of the Management.

ESSENTIAL STEPS FOR PREPARING BUDGET

- Clear Organisation Structure with division of responsibility
- Clear Objectives and Targets in line with Co's Vision
- Clearly communicated to management and person responsible
- Prepared for future periods based on expected course of action
- Flexible and Adjustable to unexpected events or changes
- Commitment of All
- Linkage with Reward System
- Periodic Monitoring

OBJECTIVES OF BUDGETING

Planning

- Planning is the beginning of any activity.
- Planning establishes the objectives of the firm and decides the course of action to achieve it
- It is concerned with formulating short-term and long-term plans to achieve a particular end.
- Planning is a statement of what should be done, how it should be done and when it should be done.
- Establishing specific targets for future operations is part of the planning function of management, while executing actions to meet the goals is the directing function of management.
- Budget reflects plans. Therefore, planning should precede the preparation of budget.
- Budgeted plans are quantified and responsibility is assigned to the persons who are responsible for execution of plan.

Directing and Coordinating

- Once the budget plans are in place, these can be used to direct and coordinate operations in order to achieve the stated targets.
- The budget offers an important tool to direct and coordinate business activities and units to achieve stated targets of performance.
- Objectives of each responsibility centre and degree of performance expected from them are separately communicated.

Controlling

- Control is the process of monitoring, measuring, evaluating and correcting actual results to ensure that a firm's goals and plans are achieved. Control is achieved through the process of feedback.
- As time passes, the actual performance of an operation can be compared against the planned targets. This provides prompt feedback to employees about their performance. If necessary, employees can use such feedback to fine-tune their activities in the future.
- Any unforeseen changes into the conditions which were prevailing at the time of preparing budget are taken into account and budgets are revised to show true performance.
- Comparing actual results to the plan helps prevent unplanned expenditures. The budget helps employees to regulate their spending priorities.

BUDGETARY CONTROL

Meaning

It is the system of management control and accounting in which all the operations are forecasted and planned in advance to the extent possible and the actual results compared with the forecasted and planned results.

Budgetary Control Involves

- Establishment of budgets
- Continuous comparison of actuals with budgets for achievement of targets.
- Revision of budgets after considering the changes in the circumstances.
- Fixation of the responsibility for failure to achieve the budget targets.

Objectives of Budgetary Control System

- Portraying with precision the overall aims of the business and determining targets of performance for each section or department of the business.
- Laying down the responsibilities of each of the executives and other personnel so that everyone knows what is expected of him and how he will be judged. Budgetary control is one of the few ways in which an objective assessment of executives or department is possible.
- Providing a basis for the comparison of actual performance with the predetermined targets and investigation of deviation, if any, of actual performance and expenses from the budgeted figures. This naturally helps in adopting corrective measures
- Ensuring optimum use of available resources to maximise profit or production, subject to the limiting factors. Since budgets cannot be properly drawn up without considering all aspects, usually there is good co-ordination when a system of budgetary control operates.
- Co-ordinating various activities of the business, and centralising control and yet enabling management to decentralise responsibility and delegate authority in the overall interest of the business.
- Engendering a spirit of careful forethought, assessment of what is possible and an attempt at it. It leads to dynamism without being reckless. Of course, much depends on the objectives of the firm and the dynamism of its management.
- Providing a basis for revision of current and future policies.
- Drawing up long range plans with a fair measure of accuracy.
- Providing a yardstick against which actual results can be compared.

Steps for establishing Budgetary Control

- Determining the objectives to be achieved, over the budget period, and the policy or policies that might be adopted for the achievement of these objectives.
- Determining the activities that should be undertaken for the achievement of the objectives.
- Drawing up a plan or a scheme of operation in respect of each class of activity, in quantitative as well as monetary terms for the budget period.
- Laying out a system of comparison of actual performance by each person, or department with the relevant budget and determination of causes for the variation, if any.
- Ensuring that corrective action will be taken where the plan has not been achieved and, if that is not possible, for the revision of the plan.

Feedback and Feedforward Control

There are two types of budgetary control system based on timing of action:

- **Feedback Control:** The feedback system of budgetary control, the actual results for the budgeted period are collected and compared with the budgeted figures. The exercise of variance identification is done after the completion of the budget period. The variances are reported and based on the report corrective actions are taken, responsibility is fixed and based on experience, modification in future targets is implemented. As the name suggests, it is an **Ex-post Corrective control** system of budget. Though this type of control system is less expensive to maintain but has limitations. Organisation has to remain on looser side in today's age of data warfare.
- **Feedforward Control:** This is the opposite of feedback control system of budgetary control. It is **Ex-Ante Preventive control** mechanism of budgetary control. The budgets are set at the inception of the budgeted period and the actual results are continuously monitored and compared. The targets are kept realistic as far as possible and the targets are reviewed and reset if necessary. This system is very expensive and beneficial for the organisations where the business environment is dynamic and information has important role in getting edge in competition and today's data warfare

Budget Committee and Budget Officer

- The budget committee is a group of representatives of various functions in an organisation. As all functions are inter-related and as any change in one's target will have its impact on that of the other, it is necessary to discuss the targets so that a mutually agreed programme is finally decided. This is called coordination in budget-making. It is a powerful force in knitting together various activities of the business and enforcing real control over operations.
- The Chief Executive is ultimately responsible for the budget programme but it will be better if the large part of the supervisory responsibility is delegated to an official designated as Budget Officer. The budget Officer should have knowledge of the technical side of the business and should report to the president or CEO of the business entity.
- The main responsibilities of the Budget Committee/Budget Officer are to:
  - Assist in the preparation of the separate budget for various departments
  - Forward the budget to the individual departments heads who are responsible
  - Prepare the periodical budget reports
  - Follow-up action to be taken on the budget reports;
  - Prepare an overall budget working report
  - Prepare periodical reports

Components of Budgetary Control System

The policy of a business for a defined period is represented by the master budget, the detailed components of which are given in a number of individual budgets called functional budgets.

- **Physical Budgets:** Those budgets which contain information in quantitative terms such as the physical units of sales, production etc. This may include quantity of sales, quantity of production, inventories, and manpower budgets are physical budgets.
- **Cost Budgets:** Budgets which provides cost information in respect of manufacturing, administration, selling and distribution, etc. for example, manufacturing costs, selling costs, administration cost, and research and development cost budgets are cost budgets.
- **Profit Budgets:** A budget which enables the ascertainment of profit. For example, sales budget, profit and loss budget, etc.
- **Financial Budgets:** A budget which facilitates in ascertaining the financial position of a concern, for example, cash budgets, capital expenditure budget, budgeted balance sheet etc.

BUDGETARY CONTROL

Advantages of Budgetary Control System	
Efficiency	The use of budgetary control system enables the management of a business entity to conduct its business activities in an efficient manner.
Control on expenditure	It is a powerful instrument used by business entity for the control of their expenditure. It provides a yardstick for measuring and evaluating the performance of individuals and their departments.
Finding deviations	Budget reveals the deviations of the actual from the budgeted figures after making a comparison and communicating the deviation to mgt.
Effective utilisation of resources	Like men, material, machinery and money is made possible, as the production is planned after taking these into account.
Revision of plans	Budget helps in the review of current trends and framing of future policies.
Implementation of Standard Costing	Budget creates suitable conditions for the implementation of standard costing system in a business organisation.
Cost Consciousness	Budgetary control system encourages cost consciousness and maximum utilisation of available resources.
Credit Rating	Management which has developed a well-ordered budget plans and which operate accordingly, receive greater favour from credit agencies.

Limitations of Budgetary Control System	
Based on Estimates	Budgets are based on a series of estimates, which are based on the conditions prevalent or expected at the time budget is established. It requires revision in plan if conditions change.
Time factor	Budgets cannot be executed automatically. Some preliminary steps are required to be accomplished before budgets are implemented. It requires proper attention and time of management. Management must not expect too much during the initial development period.
Co-operation Required	Staff co-operation is usually not available during the initial budgetary control exercise. In a decentralised organisation, each unit has its own objective and these units enjoy some degree of discretion. In this type of organisation structure, coordination among different units is required. The success of the budgetary control depends upon willingness.
Expensive	The implementation of budget is somewhat expensive as proper organisation structure with responsibility is prerequisite. It consumes valuable resources (in terms of qualified manpower, equipment, etc.) for this purpose; hence, it is an expensive process.
Not a substitute for mgt.	Budget is only a managerial tool and must be intelligently applied for management to get benefited. Budgets are not a substitute for good management.
Rigid document	Budgets are sometime considered as rigid documents. In reality, an organisation is exposed to various uncertain internal and external factors. Budget should be flexible enough to incorporate ongoing developments affecting the very purpose of the budget.

BUDGETS AND MOTIVATION

Motivation

When pursuing some target, the end result of achieving the goal should be motivating one. Motivation is a factor which works like fuel to get hope lighted and ignites aspirations. Therefore, motivation is the driving force which converts the efforts into results and thus the long-term objectives of the any person whether it would be an individual or a corporate. There must be something motivating in achieving the targets.

Considerations to make budget motivating	
Performance measurement	the achievement of targets should have consideration in measurement and evaluation of performance an executive at individual level and at departmental level. Rewards such as promotion, increment, Performance related pay, bonus may be appropriate motivation factors.
Achievable Targets	The targes should be balance one, it neither be very easy nor too tough, means it should be realistic one.
Optimum utilisation of resources	Pressure sometime forcing to explore innovative ways to get things done. Thus, to keep motivation alive, a balanced approach should be applied for optimum utilisation of resources upto its effort zone, though beyond the comfort zone.
Involvement in budgeting process	The participative budgeting motivates the executives and give them a sense of ownership. Involvement at planning stage of budget can take care of the requirements of the executives and force them accept the targets.

PREPARATION OF BUDGETS

Defining business or organisational objectives

The organisational objectives should be written down; the areas of control demarcated; and items of revenue and expenditure to be covered by the budget clearly stated

Identification of the key budget factor

There are usually one or two key budget factors (sometimes there may be more than two) which set a limit to the total activity like demand or production capacity. It must be identified & should be considered in budget.

Appointment of controller/officer

Formulation of a budget usually requires service of a whole time senior executive. The Budget Controller/Officer is responsible for coordinating and development of budget programmes and preparing the manual of instruction, known as Budget Manual

Budget Manual

- It is a booklet specifying the objectives of an organisation in relation to its strategy. As per CIMA It is a document which sets out the responsibilities of the persons engaged in, the routine of, and the forms and records required for, budgetary control.
- **Contents of Budget Manual:**
  - A statement regarding the objectives of the organisation and how they can be achieved through budgetary control;
  - A statement about the functions and responsibilities of each executive, both regarding preparation and execution of budgets;
  - Procedures to be followed for obtaining the necessary approval of budgets. The authority of granting approval should be stated in explicit terms.
  - A form of organisation chart to show who are responsible for the preparation of each functional budget and the way in which the budgets are interrelated.
  - A timetable for the preparation of each budget.
  - The manner of scrutiny and the personnel to carry it out;
  - Reports, statements, forms and other record to be maintained;
  - The accounts classification to be employed.
  - The reporting of the remedial action;
  - the manner in which budgets, after acceptance and issuance, are to be revised or the matter amended these are included in budgets and on which action can be taken only with the approval of top management
  - This will prevent the formation of a 'bottleneck' with the late preparation of one budget holding up the preparation of all others.
  - Copies of all forms to be completed by those responsible for preparing budgets, with explanations concerning their completion.
  - A list of the organization's account codes, with full explanations of how to use them.
  - Information concerning key assumptions to be made by managers in their budgets, for example the rate of inflation, key exchange rates, etc.

Budget period

There is no general rule governing the selection of the budget period. Normally, a calendar year or a period co-terminus with the financial year is adopted. it may be monthly or quarterly or for such periods as coincide with period of trading activity of the business.

Standard of activity or output

The past usually represents a combination of good and bad factors. Therefore, though results of the past should be studied, but these should only be applied when there is a likelihood of similar conditions repeating in the future. Therefore, what was good in the past is only fair for the current year and should work for much better in the future.

Special Note

In budgeting, fixing the budget of sales, expenses, and of capital expenditure is important since these budgets determine the extent of development activity. For budgeting sales, one must consider the trend of economic activity of the country, recommendations of salesmen, customers and employees, effect of price changes on sales, the provision for advertisement campaign plan capacity etc.

BUDGET BASED ON CAPACITY OR FLEXIBILITY

Fixed Budget

- A budget prepared on the basis of standard or fixed level of activity is known as fixed budget.
- It is a budget designed to remain unchanged irrespective of the level of activity actually attained.
- It shows the expected results of a responsibility center for only one activity level
- **Essential Conditions** to use Fixed Budget:
  - When the nature of business is not seasonal.
  - There is no impact of external factors on the business activities.
  - The demand of the product is certain and stable.
  - Supply orders are received and issued regularly.
  - The market of the product is normally domestic but it can also apply in respect of service export, where fairly regular export orders are received
  - There is no need of special labour or material in the production of the products.
  - Supply of production inputs is regular.
  - There is a trend of price stability.
- Generally, all above conditions are not found in practice. Hence fixed budget is not suitable in business concerns.
- **Merits:**
  - Very simple to understand
  - Less time consuming
- **Demerits:**
  - It does not suite a dynamic organization and may give misleading results. A poor or good performance may remain un-noticed.
  - It is not suitable for long period.
  - It is also found unsuitable particularly when the business conditions are changing constantly
  - Accurate estimates are not possible.

~~Fixed~~ Budget flexible

- **Meaning:** A flexible budget is a budget which, by recognizing the difference in behaviour between fixed and variable costs in relation to fluctuations in output, turnover, or other variable factors, is designed to change appropriately with such fluctuations
- **Suitability for flexible budget:**
  - Seasonal fluctuations in sales and/or production, for example in soft drinks industry;
  - a company which keeps on introducing new products or makes changes in the design of its products frequently;
  - industries engaged in make-to-order business like ship building;
  - an industry which is influenced by changes in fashion; and
  - general changes in sales.
- **Merits:**
  - sales, costs and profit may be calculated easily by the business at various levels of production capacity.
  - In flexible budget, adjustment is very simple according to change in business conditions.
  - Mgt. can easily select the level of production which shows the profit predetermined by the owners of the business.
  - It also shows the quantity of product to be produced to earn determined profit.
- **Demerits:**
  - The formulation of flexible budget is possible only when there is proper accounting system maintained, perfect knowledge about the factors of production and various business circumstances is available.
  - Flexible Budget also requires the system of standard costing in business.

FIXED AND FLEXIBLE BUDGETS

FIXED BUDGETS	FLEXIBLE BUDGETS
It does not change with actual volume of activity achieved. Thus, it is known as rigid or inflexible budget.	It can be re-casted on the basis of activity level to be achieved. Thus, it is not rigid.
It operates on one level of activity and under one set of conditions. It assumes that there will be no change in the prevailing conditions, which is unrealistic.	It consists of various budgets for different levels of activity.
Here as all costs like - fixed, variable and semi-variable are related to only one level of activity so variance analysis does not give useful information.	Here analysis of variance provides useful information as each cost is analysed according to its behaviour.
If the budgeted and actual activity levels differ significantly, then the aspects like cost ascertainment and price fixation do not give a correct picture.	Flexible budgeting at different levels of activity facilities the ascertainment of cost, fixation of selling price and tendering of quotations
Comparison of actual performance with budgeted targets will be meaningless specially when there is a difference between the two activity levels.	It provides a meaningful basis of comparison of the actual performance with the budgeted targets

FUNCTIONAL BUDGETS

Sales Budget

- Sales forecast is the commencement of budgeting and hence sales budget assumes primary importance.
- The quantity which can be sold may be the principal budget factor in many business undertakings.
- The sales budget is prepared for each product which includes quantity of estimated sales and expected unit selling price.
- In estimating the quantity of sales for each product, past sales volumes are often used as a starting point and adjusted for expected factors that affect future sales like
  - Backlog of unfulfilled sales orders
  - Planned advertising and promotion
  - Expected industry and general economic conditions
  - Productive capacity
  - Projected pricing
  - Findings of market research studies
  - Relative product profitability.
  - Competition
- Sales budget is not merely a sales forecast. A budget is a planning and control document which shows what the management intends to accomplish. Thus, the sales budget is active rather than passive document.
- A forecast reflects the environmental or competitive situation facing the company whereas the sales budget shows how the management intends to react to this environmental and competitive situation.

Plant Utilisation Budget

- Plant utilisation budget represents, in terms of working hours, weight or other convenient units of plant facilities required to carry out the programme laid down in the production budget.
- Main purpose of this budget are:
  1. To determine the load on each process, cost or groups of machines for the budget period.
  2. To indicate the processes or cost centres which are overloaded so that corrective action may be taken such as: (i) working overtime (ii) sub-contracting (iii) expansion of production facility, etc.
  3. To dovetail (balance) the sales production budgets where it is not possible to increase the capacity of any of the overloaded processes.
  4. Where surplus capacity is available in any of the processes, to make effort to boost sales to utilise the surplus capacity.

Production Budget

- Production Budget is a forecast of the production for the budget period of an organization.
- Production budget shows the production for the budget period based upon:
  - Sales budget,
  - Production capacity of the factory,
  - Planned increase or decrease in finished stocks, and
  - Policy governing outside purchase.
- It is a physical budget, so number of units to be manufactured to meet budgeted sales and inventory needs for each product is set forth in the production budget.
- The production facility available and the sales budget will be compared and coordinated to determine the production budget. If production facilities are not sufficient, consideration may be given to such factors as working overtime, introducing shift working, sub-contracting or purchasing of additional plant and machinery. If, however, the production facilities are surplus, consideration should be given to promote advertising, reduction of prices to increase the sales, sub-contracting of surplus capacity, etc.
- Level of Stocks will depend upon the following three factors:
  - Seasonal industries in which stocks have to be built up during off season to cater to the peak season
  - A steady and uniform level of production to utilise the plant fully and to avoid retrenchment or lay-off of the workers, and
  - To produce in such a way that minimum stocks are maintained at any time to avoid locking up of funds in inventory.

Direct Material Usage Budget & Purchase Budget

- **Material Usage:** It includes the physical units of each Raw Material based on the production budget and corresponding rate to also show the cost. Here we need to consider quality standards and normal loss also.
- **Material Purchase:** It is based on material usage budget and adjusted with planned inventories to get budgeted purchase quantities. Considerations should be given to ROQ, Re-order Level.

Labour Cost Budget

- Based on Production Budget we can estimate hours requirement of different grades of labour to produce the same.
- Budgeted hours can be used to calculate number of workers required and then Wages Budget by multiplying their hours with wage rate.
- **Merits/ advantages:**
  - It defines the direct and indirect labour force required.
  - It enables the personnel department to plan ahead in recruitment and training of workers so that labour turnover can be reduced to the minimum.
  - It reveals the labour cost to be incurred in the manufacture, to facilitate preparation of manufacturing cost budgets and cash budgets for financing the wage bill.

Production or Factory Overhead Budget

- Factory overhead budget usually includes the total estimated cost for each item of factory overhead.
- A **few examples** are given below to show how the expenses are estimated.
  - Fixed expenses are normally policy costs and hence they are based on policy matters.
  - For estimating indirect labour, work study is resorted to and a estimate of number of indirect workers required for each level of direct workers employed is made - for example, one supervisor for every twenty direct workers.
  - In regard to the estimate of consumption of indirect materials, the age and condition of the plant and machinery are taken into consideration.

Production Cost Budget

- Production cost budget covers direct material cost, direct labour cost and manufacturing expenses.
- After preparing direct material, direct labour and production overhead cost budget, one can prepare production cost budget.

Ending Inventory Budget

- This budget shows the cost of closing stock of raw materials and finished goods, etc. required to be maintained by the business entity.
- This information is required to prepare cost-of-goods-sold budget and budgeted financial statements i.e., budgeted income statement and budgeted balance sheet.

FUNCTIONAL BUDGETS

Selling and Distribution Cost Budget

- All expenses connected with advertising, sales promotion, sales office, salesmen, credit collection, market research, after sales service, etc. are generally grouped together to form part of the responsibility of the sales manager.
- While making a budget, selling costs are divided into fixed and variable. Semivariable costs should also be separated into variable and fixed elements.
- The problems faced in the preparation of selling cost budgets are:
  - Heavy expenditure on selling and sales promotion may have to be incurred when the volume of sales is falling off
  - Sometimes intensive sales and promotion efforts are called for in one year and the benefit of such efforts accrue in the subsequent years.
  - In spite of these problems, some relationship between selling cost and volume of sales has to be established and it is the duty of the Budget Controller to determine the amount of selling costs to be incurred to achieve the desired level of sales volume.
- When preparing the advertisement cost budget, consideration should be given to the following factors:
  - The best method of advertisement must be selected; costs will vary according to the method selected.
  - The maximum amount to be spent in a period, say one year, has to be decided.
  - Advertising and sales should be co-ordinated.
  - An effective control over advertisement expenditure should be exercised and the effectiveness of the advertisement should be measured.

Administrative Expenses Budget

- The administrative expenses are mostly policy costs and are, therefore, fixed in nature.
- The most practical method to follow in preparing estimate of these expenses is to follow the past experience with due regard to anticipated changes either in general policy or the volume of business.
- Examples of such expenses are: board meeting expenses, expenditure incurred on staff employed in human resources and finance departments, audit fees, depreciation of office equipment, insurance, subscriptions, postage, stationery, telephone, telegrams, office supplies, etc

Research and Development Cost Budget

- Research is required in order to develop and/or improve products and methods.
- When research results in definite benefit to the company, development function begins.
- After development, formal production can commence on commercial scale and then production function starts.
- Research and Development (R & D) plays a vital role in maintaining the business. For example, automobile manufacturers, and those who produce drugs, spend considerable sums on R&D to improve their products.
- Research and development expenses should be controlled carefully and hence a limit on the spending is placed, i.e., the amount to be spent is carefully determined or allocated.

Capital Expenditure Budget

- The capital expenditure budget represents the planned outlay on fixed assets like land, building, plant and machinery, etc. during the budget period.
- This budget is subject to strict management control because it entails large amount of expenditure.
- The preparation of capital budget is based on the following considerations:
  - Future development plans to increase output by expansion of plant facilities.
  - Replacement requests from the concerned departments.
  - Actors like sales potential to absorb the increased output, possibility of price reductions, increased costs of advertising and sales promotion to absorb increased output, etc.
- **Merits/ Advantages of Capital Budgeting:**
  - It enables the company to establish a system of priorities.
  - It serves as a tool for controlling expenditure.
  - This enables the cash budget to be completed.
  - It facilitates cost reduction programme, particularly when modernisation and renovation is covered by this budget.

Cash Budget

- Cash Budget is a detailed budget of cash receipts and cash payments incorporating both revenue and capital items for the budget period.
- This budget is usually of two parts giving detailed estimates of (i) cash receipts and (ii) cash disbursements.
- It is the plan of receipts and payments of cash for the budget period, analysed to show the monthly flow of cash drawn up in such a way that the balance can be forecasted at regular intervals.
- **Main objectives** of cash budget:
  - The probable cash position, as a result of planned operation, is assessed;
  - This helps in arranging short-term borrowings in advance to meet the situations of shortage of cash or making investments when cash is in excess.
  - Cash can be coordinated in relation to total working capital, sales investment and debt.
  - A sound basis for credit for current control of cash position is established.

MASTER BUDGET

Meaning

- The summary budget, incorporating its component functional budgets, which is finally approved, adopted and employed.
- When all the necessary functional budgets have been prepared, the budget officer will prepare the master budget which may consist of budgeted profit and loss account and budgeted balance sheet.

BUDGET CLASSIFICATION BASED ON TIME PERIOD

Long term Budget

- Long Term Budget is a budget prepared covering a period of more than a year.
- The Budgets are prepared to depict long term planning of the business.
- The period of long-term Budgets varies between three to ten years.
- These budgets are useful for those industries where gestation period is long i.e., the business entities manufacturing machinery, electricity etc.

Short term Budget

- These budgets are generally for one or two years and are in the form of monetary terms.
- The consumer's good industries like Sugar, Cotton, and textile use short term budgets.

Current Budgets

- The period of current budgets is generally of months and weeks.
- These budgets relate to the current activities of the business.

ZERO BASED BUDGETING (ZBB)

Meaning

- Zero-based Budgeting (ZBB) is defined as a method of budgeting which requires each cost element to be specifically justified, though the activities to which the budget relates are not being undertaken for the first time.
- The cost of each activity has to be justified and without justification, the budget allowance is zero.
- ZBB is an activity-based budgeting system where budgets are prepared for each activity rather than functional department.
- ZBB is suitable for both corporate and non-corporate entities.
- In case of non-corporate entities like Government department, local bodies, not for profit organisations, where these entities need to justify the benefits of expenditures on social programmes like mid-day meal, installation of street lights, provision of drinking water etc.
- In case of corporate entities, ZBB is best suited for discretionary costs like research and development cost, training programmes, advertisement etc.

Stages in Zero-based Budgeting

Identification and description of Decision packages	Decision packages are the programmes or activities for which decision is required to be taken. The programmes or activities are described for technical specifications, financial impact in the form of cost benefit analysis and other issues like environmental, regulatory, social etc.
Evaluation of Decision packages	Once Decision packages are identified and described, it is evaluated against factors like synchronisation with organisational objectives, availability of funds, regulatory requirement etc.
Ranking (Prioritisation) of the Decision packages	After evaluation of the decision packages, it is ranked on the basis priority of the activities. Because of this prioritization feature ZBB is also known as Priority-based Budgeting.
Allocation of resources	After ranking of the decision packages, resources are allocated for decision packages. Budgets are prepared like it is done first time without taking reference to previous budgets.

Advantages of Zero-based Budgeting

- It provides a systematic approach for the evaluation of different activities and rank them in order of preference for the allocation of scarce resources.
- It ensures that the various functions undertaken by the organization are critical for the achievement of its objectives and are being performed in the best possible way.
- It provides an opportunity to the management to allocate resources for various activities only after having a thorough cost-benefit-analysis. The chances of arbitrary cuts and enhancement are thus avoided.
- The areas of wasteful expenditure can be easily identified and eliminated.
- Departmental budgets are closely linked with corporation objectives.
- The technique can also be used for the introduction and implementation of the system of 'management by objective'

Traditional Budgeting vs ZBB

- Traditional budgeting is accounting oriented. Main stress happens to be on previous level of expenditure. Zero-based budgeting makes a decision-oriented approach.
- In traditional budgeting, first reference is made to past level of spending and then demand for inflation and new programmes. In zero- based budgeting, management focuses attention to only on decision packages, which enjoy priority to others.
- In tradition budgeting, some managers deliberately inflate their budget request so that after the cuts they still get what they want. In zero-based budgeting, a rationale analysis of budget proposals is attempted.
- Traditional budgeting is not as clear and as responsive as zero based budgeting.

Limitations of ZBB

- The work involves in the creation of decision-packages and their subsequent ranking has to be made on the basis of new data. This process is very tedious to management.
- The activities selected for the purpose of ZBB are on the basis of the traditional functional departments. So, the consideration scheme may not be implemented properly.

BUDGET RATIOS

Meaning

- Budget ratios provide information about the performance level, i.e., the extent of deviation of actual performance from the budgeted performance and whether the actual performance is favourable or unfavourable.
- If the ratio is 100% or more, the performance is considered as favourable and if ratio is less than 100% the performance is considered as unfavourable.

PERFORMANCE BUDGETING

Meaning

- Performance budgeting requires fixing of the responsibility of each executive in organisation and the continuous appraisal of his performance.
- It is, therefore, considered to be synonymous with responsibility accounting
- Programmes and activities are correlating the physical and financial aspect of the individual items comprising the budget.

Traditional Budgeting vs. Performance Budgeting

- The traditional budgeting gives more emphasis on the financial aspect than the physical aspects or performance.
- Traditional budgets are generally prepared with the main basis towards the objects or items of expenditure i.e., it highlights the items of expenditure, namely, salaries, stores and materials, rates, rents and taxes and so on. In the PB emphasis is more on the functions of the organisation, the programmes to discharge this function and the activities which will be involved in undertaking these programmes.

Steps in Performance Budgeting

According to the Administrative Reforms Commission (ARC), the following **steps** are the basic ones in PB:

- Establishing a meaningful functional programme and activity classification of government operations.
- Bring the system of accounting and financial management in accordance with this classification.
- Evolving suitable norms, yardsticks, work units of performance and units costs, wherever possible under each programme and activity for their reporting and evaluation.

Pre-requisites to adopt PB

- the objectives of the enterprise are spelt out in concrete terms.
- the objectives are then translated into specific functions, programmes, activities and tasks for different levels of management within the realities of fiscal constraints;
- realistic and acceptable norms, yardsticks or standards and performance indicators should be evolved and expressed in quantifiable physical units.
- a style of management based upon decentralised responsibility structure should be adopted, and
- an accounting and reporting system should be developed to facilities monitoring, analysis and review of actual performance in relation to budgets.

consideration in drawing up of performance reports

Significance	Are the facts in the reports reliable? Does it either called for action or demonstrate the effect of action?
Timeliness	How late can the information be and still be of use? What is the earliest moment at which it could be used if it were available? How frequently is it required?
Accuracy	How small should be an inaccuracy which does not alter the significance of the information?
Appropriateness	Is the recipient the right person to take any action that is needed? Is there any other information which is required to support the information to anyone else jointly interested?
Discrimination	Will anything be lost by omitting the item? Will any of the items gain from the omission? Is the responsibility for suppressing the item acceptable?
Presentation	Is the report clear and unbiased? Is the form of it is suitable to the subject? Is the form of it suitable to the recipient?

Types of reports

Top Management	Balance Sheet, Profit & Loss Statement, Position of stocks, Disposition of funds or working capital, Capital expenditure and forward commitments together with progress of projects in hands, Cash-flow statements, Sales, production, and other appropriate statistics.
Sales Management	• Actual sales compared with budgeted sales to measure performance and selling expenses by – Products, Territories, Salesman, Customers • Standard profit and loss by product for fixing prices and concentrate on more profitable products • Bad debts and accounts which are slow and difficult in collection. • Status reports on new or doubtful customers.
Production Management	**To Foreman:** Operational efficiency for individual operators duly summarized as departmental average; Labour utilization report and causes of lost time and controllable time; Indirect shop expenses against the standard allowed and scrap report **To Works Managers:** Departmental operating statement; Plant utilization report; Department Scrap report; Material usage report.
Special Reports	These reports may be prepared at the request of general management or at the initiative of the management accountants. Some of the matters in respect of which such reports may be required can be: • Taxation legislation and its effect on profits. • Estimates of the earning capacity of a new project. • Break-even analysis • Replacement of capital equipment. • Make or buy certain components