Budgets and Budgetary Control

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Abstract
This study deals with budget, budgeting and budgetary control. Also pros and cons of budgetary control, steps of preparing budget and finally different types of budgets are discussed.

Keywords: budget, budgetary control

Budget
A budget is a formal expression of policies, plans, objectives and goals laid down for a definite period in the future. The budget expresses revenue goals in the sales budget and expense limitations in the expense budgets that must be attained in order to realize the desired profit objective.

The Institute of Cost and Management Accountants, London, defines budgets as, "Financial and/or quantitative statements, prepared prior to a definite period of time, of the policy to be pursued during that period for the purpose of attaining a given objective."

The basic elements of a budget are:
- It is a future plan of activity for a specified period of time.
- It is expressed in physical or monetary units or in both.
- It is prepared in advance, i.e., before the period during which it is to operate.
- The objectives to be attained and the policy to be pursued to achieve those objectives are required to be laid down before its preparation.

Budgetary Control
Budgetary control involves the use of budgets and budgetary reports throughout the period of budget to coordinate, evaluate and control day-to-day operations in accordance with the goals specified by the budget. Budgetary control involves a constant checking and evaluation of actual results compared with the budgeted goals, which should result in corrective action where indicated.

The Institute of Cost and Management Accountants, London, defines budgetary control as, "The establishment of budgets relating the responsibilities of executives to the requirements of a policy, and the continuous comparison of actual with budgeted results, either to secure by individual action the objective of that policy or to provide a basis for its revision."

The process of budgetary control involves the following steps:
a) Defining and specifying the objectives to be achieved by the business.
b) Preparing business plans in order to ensure that the desired objectives are accomplished.
c) Translating the plans into budgets, and relating the responsibilities of individual executives and managers to particular sections of the budget.
d) Continuous comparison of actual results with the budget, and the calculation of differences between the budgeted and actual performance.
e) Investigating major differences in order to establish the causes.
f) Presentation of the information to management in a suitable form, relating the variances to individual responsibility.
g) Corrective action by the management in order to avoid a repetition of any wastage or over-expenditure. Alternatively, where it is not possible to achieve the budgeted targets due to change in circumstances, the revision of the budget.

Difference between Budget, Budgeting and Budgetary Control
The difference between budget, budgeting and budgetary control may be stated thus — Budgets are the individual objectives of a department, etc. whereas budgeting may be said to be the act of setting budgets. Budgetary control embraces all and includes the science of planning the budgets themselves and utilisation of such budgets as an overall management tool for the business planning and control. Thus, the term budgetary control is wider in meaning and it includes both budget and budgeting.

Objectives of budgetary control are
a) To Compel Planning. This is the most important feature of budgetary control, because management is forced to look ahead, set targets, anticipate problems and give the organisation purpose and direction.
b) To communicate ideas and plans to everyone affected by them. It is necessary.
c) To have a formal system to make sure that each person is aware of what he is supposed to be doing.
d) To co-ordinate the activities of different departments or sub-units of the organisation. This concept of co-ordination implies, for example, that the purchasing department should base its budget on production requirements, and that the production budget should in turn be based on sales expectations.

e) To establish a system of control by having a plan against which actual results can be progressively compared.

f) To motivate employees to improve their performance.

**Requisites of an effective system of Budgetary Control**

a) A clearly defined organisational structure, which emphasizes areas of responsibility.

b) Adequate accounting records and procedures, so that measurement of performance may be relied on.

c) Participation by individuals within the budgeting process.

d) Awareness by management of the uses of the budgetary control system.

e) Awareness by the top management of the problems of budgetary control, and especially of the reaction of individuals to budgets.

f) Flexibility, so that plans and objectives may be revised.

**Advantages of Budgetary Control**

The advantages of a budgetary control system are as follows:

a. It defines the objectives of the organisation as a whole, and within this overall framework, it defines the results which each department should achieve.

b. It reveals the extent by which actual results have exceeded or fallen short of the budget.

c. It indicates, with variances or other measures of performance, the reasons why actual results differ from those budgeted, and establishes the magnitude of the differences.

d. As a result of reporting on actual performance along with variances and other performance measures, it provides a basis for guiding executive action to correct adverse trends.

e. It provides a basis for the revision of the current budget, or for the preparation of future budgets.

f. It provides a system whereby the resources of the organisation are used in the most efficient way possible.

g. It indicates the efficiency with which the various activities of the organisation have been co-ordinate.

h. It provides some centralizing control where activities and responsibilities are decentralised.

i. Where the activities of an organisation are subject to seasonal variations, it provides a means of stabilizing the organisation’s activities.

j. It establishes a basis for internal audit by means of regular examination of departmental results.

k. It enables standard costs to be used.

l. It provides a basis for measuring productive efficiency with a view to paying a bonus to employees.

**Limitations of Budgetary Control**

The principal limitations of budgetary control are:

a. Estimates are used as a basis for the budget plan.

b. A budgetary programme must be continually adapted to fit changing circumstances. Normally it takes several years to attain a reasonably good budgetary programme.

c. Execution of a budget plan does not occur automatically. All levels of the management must participate enthusiastically in the programme.

d. No budgetary control system will eliminate the necessity of having a management and administration. It does not take the place of management, but is rather a tool of the management.

**Steps in Preparing a Budget**

Preparing a budget involves the following steps:

a. Establish budget centres (for the purposes of budgetary control).

b. Prepare a clearly defined organisational chart stating the functional responsibilities of each member of the management team.

c. Prepare a budget manual (specifies in detail the procedures to be followed).

d. Form a budget committee (for co-ordinating and reviewing the budget programme).

e. Determine the limiting or key factor.

f. Select the budget period (period of time for which the budget is prepared and employed).

g. Set objectives to be reached by the end of the budget period.

h. Prepare forecasts for the period.

i. Determine enterprise policies (e.g., product range, normal hours of work per week, channels of distribution, stocks, research and development appropriation, investments).

j. Compute from the forecasts the requirements in terms of the economic quantities needed to meet the objectives while complying with the policies — and subsequently convert these quantities into monetary values. This results in an initial provisional budget.

k. Review this initial budget with respect to the planned objectives and amend objectives or policies or both repeatedly until an acceptable budget emerges.

l. Formally accept the budget which then becomes the master budget and as such is an executive order.
Distinction between Forecast and Budget

A forecast has been defined as the prediction of relevant future factors affecting an entity and its environment as a means to facilitate the preparation of planning decisions. A forecast is a prediction of what is likely to happen, whereas a budget is a plan of what organisation has set itself as a target for what should happen. A forecast is a judgment can be made by anybody, whereas a budget is an enterprise objective that may be made only by the authorized management. A forecast forms the basis for the budget. A budget statement of planned events generally evolved from the forecast. The forecast of a function need not necessarily be well co-ordinated. Budgeting involves a good co-ordination and functions of an organisation to attain the desired results. The forecasts may cover a period ranging from one to five years, or longer in the case of certain types of businesses. The budgets, however, are rarely projected for more than a year in advance, except in the case of capital expenditure budget, and often are projected for only three months. Budgeting involves the control of variations from the approved plan in order that the desired results may be achieved. Forecasting does not involve any such control.

Types of Budget

Functional Budget

A functional budget is a budget which relates to a major function of the business. The usual functional budgets are:

a. Sales Budget: The budget shows sales in terms of quantity and value, analysed by the product, by month, by region, by channel of distribution and by salesman.
b. Selling Expenses Budget: The budget includes salesmen's salaries, commission, expenses, and related administrative costs.
c. Distribution Expenses Budget: The budget is made up of transportation, freight charges, stock control, warehousing, wages, expenses, and related administrative costs.
d. Marketing Budget: Apart from details of all advertising, promotional activities, public relations, marketing research, customer service, and so forth, the marketing budget can also include a summary of the sales, selling expenses and distribution expenses budgets.
e. Research and Development Budget: The budget covers materials, equipment, supplies, salaries, expenses, and other costs relating to design, development and technical research projects.
f. Production Budget: The aim of the production function is to supply finished goods of a specified quality to meet market demands. The distribution budget specifies finished goods stock levels, and this can be related to the sales budget to give detailed production requirements. Following from this, it is necessary to consider a series of subsidiary budgets:

- Raw Materials Budget: It pays appropriate attention to the desired stock levels.
- Labour Budget: It ensuring that the plan will make available at the right times the required number of employees of suitable skills
- Manufacturing Overheads budget: It covering items such as consumable materials and waste disposal.
- Manpower Budget: The budget must take an overall view of the organization’s needs of manpower for all areas of activity — sales, manufacturing, administrative, executive, and so on — for a period of years. Based on the manpower budget and policies, training expenses budget and recruitment expenses budget can be formulated.
- Purchasing Budget: Raw materials, consumable items, office supplies and equipment, and the whole range of an organization’s requirements, must be considered while preparing this budget, along with the answers to the questions when, where, at what price, and how often to buy.
- Administration Expenses Budget: The budget deals with such expenses as office salaries and upkeep, depreciation, stationery, management salaries, telephones, postage, etc.

Financial Budget

The financial budget which summarizes the whole package of budgets is made up of five individual budgets:

- Cash Budget: It is concerned with liquidity. It shows the requirements of cash in respect of various functional budgets as well as anticipated cash receipts.
- Budgeted Profit and Loss Account: It is concerned with profitability. It reflects the matching of budgeted revenues during the period with budgeted costs during the same period.
- Budgeted Balance Sheet: It is concerned with the structure of assets and the pattern of liabilities.
- Budgeted Funds Flow Statement: It is concerned with the sources of funds and their application in the organization’s objective-striving endeavors.
- Capital Budget: It is concerned with the questions of capacity and strategic direction. It deals with the evaluation of alternative dispositions of capital funds as well as with the choice of the best capital structure.

Cash Budget

The cash budget, as its name implies, summarizes the estimated cash receipts and the estimated cash payments over the budget period. Its object is to ensure a balance between liquidity and profitability. The cash budget is
closely related to the sales forecast, expense budgets, and capital expenditure budget.

The cash budget is concerned with the timing of receipts and payments of cash (cash basis), whereas the other budgets are concerned with the timing or incurrence of the transactions themselves (accrual basis).

**Purposes of Cash Budget**
The principal purposes of the cash budget may be outlined as follows:

a. It indicates the probable cash position as a result of planned operations.
b. It indicates cash excess or shortages.
c. It indicates the need to arrange for short-term borrowing, or the availability of idk cash for investment.
d. It makes provision for the co-ordination of cash in relation to
   i. total working capital,
   ii. sales,
   iii. investment,
   iv. debt.
e. It establishes a sound basis for obtaining credit.
f. It establishes a sound basis for current control of the cash position.

**Methods of Preparing Cash Budget**
There are two methods of preparing a cash budget:

(a) receipts and payments method and
(b) funds flow method

**Distinction between Cash Budget and Cash Flow Statement**
Following are the important points of distinction between a cash budget and a cash flow statement:

a. A cash budget is futuristic in approach. It is prepared in advance and is based on future plan of action. A cash flow statement is based on past data.
b. Cash budget relates to objectives to be achieved and is a plan for future inflows id outflows of cash. A cash flow statement is a post mortem analysis of actual flows and outflows of cash.
c. The period of a cash budget is usually short (may be a week, fortnight, month or quarter). A cash budget may be prepared covering a long period also (say, a year) but divided into short sub-budget periods (say a month or quarter). The time span to be covered by a cash budget will vary from one firm to another, depending on the nature of its business and the degree of accuracy with which estimates can be made. A cash flow statement covers a relatively longer period, usually an accounting year, and it is not divided into sub-periods.
d. A cash budget requires previous data only for the purpose of judicious forecasting. A cash flow statement is prepared from accounting data at the beginning and end of an accounting year.
e. A cash budget is a tool for budgeting and controlling cash. A cash flow statement is an analysis of the working of the concern for the past accounting year.
f. A cash budget usually serves the purposes of management only. A cash flow statement may serve the purposes of management as well as external parties.

**Flexible Budget**
In some businesses it is extremely difficult to estimate future levels of activity with any accuracy because of external uncontrollable influences. For example, a business providing luxury goods and services may be very sensitive to changes in the economic climate. Some businesses are affected by weather, and weather conditions are difficult to predict.

The main requirement of a flexible budget is that expenses should be analyzed into three distinct categories:

(a) Fixed expenses, i.e., expenses which would remain the same irrespective of levels of activity?
(b) Variable expenses, i.e., expenses which would change in proportion to levels of activity.
(c) Semi-variable expenses, i.e., expenses which would need to be analyzed into the fixed and variable elements.

The advantage of flexing a budget, as already stated, is that actual performance can be compared with the flexed budget for purposes of control and performance appraisal.

**Zero-Base Budgeting (ZBB)**
As a modern technique of budgeting, considered ideal for planning and decision making, ZBB was first applied by the United States department of agriculture as early as in 1964. The conceptual framework and structural development of ZBB was made by Peter A. Pyhrr who applied it in Texas Instruments, a multinational company of United States in 1969. Peter A. Pyhrr is regarded as the "father of zero-base budgeting owing to his contribution towards the development of the technique and making of the conceptual framework. President Jimmy Carter, while in the presidential chair of the U.S.A., issued an official order in 1979 for using the technique by all federal government agencies throughout the United States. The technique was then gradually adopted by various countries all over the world.

**ZBB Concept**
Traditionally budgeting is done on the basis of the targets set in the last year. Certain additions and deductions are made in the last year's budget figures- to arrive at the figures for the current budget. Thus, in traditional budget making we depend on the last year's targets and on the principle of increment or decrement to decide upon the
additions and deletions required to the incorporated in
the previous budget figures to arrive at the current bud-
get figures.

In case of ZBB it is assumed that there was no previous
year's budget and the current budget proposals are inde-
pendently evaluated in the light of expected benefits and
costs involved. ZBB, therefore, refers to formulating a
budget without making any reference to previous plans
and achievements, but making particular reference to the
justification of the proposed allocation of resources. This
is not once. Every time a budget is to be prepared, the
process of budgeting should start from zero and the pro-
posed allocation of resources should be justified in terms
of cost-benefit analysis.

ZBB Defined
I.C.M.A., London, defined ZBB as "a method of budget-
ing whereby all activities are re-evaluated each time a
budget is formulated. Each functional budget starts with
the assumption that the function does not exist and is at
zero cost. Increments of cost are compared with incre-
ments of benefits culminating in the planned maximum
benefit given by budgeted cost."

Peter A. Pyhrr, the father of ZBB, defined ZBB as "an
operating planning and budgeting process which re-
quires each manager to justify his entire budget request
in detail from scratch. Each manager states why he
should spend any money at all. This approach requires
that all activities be identified as decision packages
which would be evaluated by systematic analysis and
ranked in order of importance."

Zero-base budgeting becomes ideal in case of planning
and decision making. Development planning includes
undertaking of various types of work of which there is
no previous experience. Budgets in these cases cannot be
based on past targets modified by certain additions
and deletions. Every budget proposal has to be evaluated
on the basis of cost-benefit analysis. All proposed activi-
ties are to be identified as decision packages to be eva-
luated by systematic analysis and ranked in order of
priority. Decision making depends on priority list.

Main Features of ZBB
The following are the principal features:

a. Zero (or scratch) is taken as the basis of budgeting
   and not the targets of previous budgets.

b. Management of each decision unit must have to
   justify the fund demanded.

c. All proposed activities are grouped into various de-
   cision packages.

d. All decision packages are adequately evaluated and
   arranged according to priority.

e. Alternative decision packages are also taken into
   consideration after evaluating properly.

f. Final allocation of resources is done on the merits of
   evaluation of all decision packages including the al-
   ternative decision packages.

How ZBB differs from Traditional Budget-
ing
The following are the points of distinction between tradi-
tional budgeting and zero-base budgeting:

a. In traditional budgeting previous level of expendi-
ture is given emphasis, whereas, in ZBB new eco-
nomic appraisal is made every time a budget is pre-
pared.

b. Traditional budgeting is an accounting oriented
   function, whereas, ZBB is project (or decision)
   oriented function.

c. For preparing a traditional budget existing pro-
   gramme need not be rejuslified, whereas, for prepa-
   ring a zero-base budget the existing and new projects
   are to be justified in the light of benefits and costs.

d. In case of a traditional budget the top management
   of the organisation justifies why a particular amount
   of expenditure is decided upon for a particular deci-
   sion unit, whereas, in case of ZBB it is the manager
   of the decision unit (and not the top management)
   who justifies the amount of expenditure.

e. In case of traditional budgeting how much is to be
   added with or deleted from the previous budget fig-
   ures is only taken into account, whereas, in case of
   ZBB appraisal of the existing level of expenditure
   is done and the future proposal for expenditure is justi-
   fied from different angles.

f. Preparing a traditional budget is a simple job mono-
   tonously done year after year, whereas, preparing a
   zero-base budget requires logical approach and it
   involves many complex steps to establish logic be-
   hind a proposal.

Applicability of ZBB
ZBB is very suitably applicable in planning and devel-
opment areas particularly of the government and local
bodies. Projects of every ministry are thoroughly ex-
amined with reference to costs and benefits. Which
projects of which ministry shall enjoy priority in respect
of allocation of resources depends upon the report of
cost-benefit examination by persons competent to do so.
Where the resources are limited but there are many de-
velopment works' to be done as in case of educational
institutions, local bodies etc. ZBB becomes ideal, be-
cause efficient use of limited resource is almost guaran-
eted.

In manufacturing concerns there are many devices like
standard cost technique, work and motion study etc. to
to control cost. These techniques help controlling the prime
costs and production overhead, because in these cases there is direct relationship between cost and output. But in manufacturing concerns there are various other expenditure which supports production function, but no relationship between cost and output can be established in these cases. This area of expenditure is a suitable field for application of ZBB. This area is covered by expenditure like accounting, research, development, maintenance, advertisement, postage, electricity, rent of administrative office and many others.

**Merits of ZBB**
The following merits of ZBB are claimed:

a. All projects — current and future are examined carefully with reference to cost and benefits and the most efficient project is accepted. Thus, ZBB is always a technique based on logic. The current projects are continued only if they are logically sound and efficient.

b. Amongst the available alternatives the most efficient ones are chosen on the cost-benefit acceptability for rational planning. ZBB requires the managers of decision units to find out cost effective ways of implementing the plans. Thus, ZBB helps making best planning and it also helps controlling cost.

c. Cost-benefit analysis is done in respect of both existing and future projects. On the basis of the result of the analysis ranking of projects is done and funds are allocated in order of priority. Thus, ZBB helps efficient allocation of funds.

d. In zero-base budgeting most useful alternatives are found out for using the available resources of the organisation. In performing an activity also, alternative ways are taken into consideration and alternative quanta of efforts to be put in are also considered. These help promoting new ideas for performing an activity in (lie best possible way.

e. Appraisal of existing activities and new projects is done, with equal importance, with regard to justifiability of continuing new undertaking on the basis of cost-benefit analysis.

f. In ZBB the managers of all decision units are to submit reports on their claims of funds and justification of the claims. Thus, in zero-base budget making, participation of all managers of decision units becomes compulsory. This promotes forthcoming of new ideas in allocation and utilisation of funds.

g. Since appraisal of the existing activities is done carefully in ZBB, activities failing to give desired results may be discontinued and thus unproductive expenditure may be saved.

h. ZBB technique being adopted all managers are obliged to make self-evaluation of projects under their command. Loopholes, if any, in the working progress are automatically detected and remedial measures are adopted. Managers’ awareness in respect of detection of errors and their rectification helps attaining efficiency in performance.

i. ZBB creates automatic motivation and helps forming a management team of individuals having talents and skills.

j. ZBB helps linking up top management with medium and lower level management. Thus, speedy communication is ensured which helps expediting appropriate decision-making.

k. ‘Management by objectives’ (or MBO) can be introduced and implemented with the help of ZBB. ZBB can be used for fulfilling the objectives of traditional budgeting, as it can be used for fulfilling other objectives as well.

**Demerits of ZBB**
The following demerits of ZBB are apprehended:

a. Collection and analysis of data of alternative future projects as well as existing activities requires time, money and energy.

b. Implementation of ZBB technique becomes difficult, if full co-operation amongst management staff is not forthcoming.

c. Evaluation often becomes very difficult, as ideal standard of evaluation is not available. Evaluation in a desired manager requires technical knowledge which may not be available.

d. Managers are to undergo continuous training. If basic idea and objectives of ZBB are not crystal clear to the managers, implementation of ZBB system in a right way can not be expected.

e. In care of ZBB projects are to be ranked according to priority. Ego of top management may lead to irrational ranking of projects (i.e., if the top management favors a projects, irrespective of its merits it may be ranked high). Moreover, confusion may arise among the management staff regarding the method of ranking to be adopted.

f. ZBB requires involvement of a good number of individuals. This may create complications in communication system, difficulty in managing the huge volume of data, involvement of voluminous paper work etc.

**References:**


