__/__/__

Unit-3

Budgetary Control

→ **Meaning:**

- System of controlling costs through preparation of budgets
- It is a system of controlling costs which includes the preparation of budgets, co-ordinating the departments and establishing responsibilities, comparing actual performance with the set budget and acting upon results to achieve maximum profitability.

→ **Steps:**

i) Establishing Objectives: First step is to define the organizations objectives and financial goals. These can be revenue targets, cost reduction targets or profit margins.

ii) Preparation of budget: Now a budget has to be prepared for forecasting revenue, estimating expenses and allocating resources accordingly. Different types of budgets are prepared as per the organization's needs.

iii) Communication and Coordination: Once budget is prepared, it needs to be communicated with all the stakeholders such as managers, heads and employees, so that everyone understands their

__/__/__

roles in achieving budgetary targets. Coordination among different departments is essential to align their activities with the budgetary goals.

iv) Implementation: After the budget is communicated, managers and employees start executing their respective plans and activities, which involves resource allocation decisions, initiating projects, controlling costs and monitoring progress.

v) Monitoring and Control: Regular monitoring of actual performance against the budget is crucial for effective control, which involves comparing actual revenues and expenses with budgeted amounts. Various financial reports are prepared to analyze the deviations. If any significant ~~are~~ found are investigated to determine the reasons behind them.

vi) Analysis and Reporting: The variances are analyzed to identify the causes of the deviations, which highlights the areas where organization is doing well and facing problems. Then reports are prepared to communicate the findings to the relevant shareholders, enabling them to take appropriate actions.

__/__/__

VII) Corrective Actions: Based on the analysis and problems identified corrective actions are taken which may involve revising the budget, ~~or~~ reallocating resources or adjusting operations and strategies, as the objective is to bring the actual results in line with the budgeted targets.

VIII) Continuous Improvement: Budgetary control is an ongoing process and organizations should strive for continuous improvement. Lessons learned from the budgetary control process should be incorporated into future budget cycles to enhance accuracy, efficiency and effectiveness.

Zero Based Budgeting

- recent development in the area of management
- In incremental approach - current year's budget is taken as the base or starting point for preparing next year's budget.
- It is not based on incremental approach.
- Budget figures are developed with zero as the base i.e. a budget is prepared as if it is being prepared for a new company for the first time.
- It is a system whereby each item, regardless of whether it is new or existing must be justified in its entirety each time a new budget is being prepared.
- It is a formalized system, as if each activity is performed for the first time i.e. from zero base.

- all budget items are considered fresh
- amount to be spent has to be justified
- department objectives are linked to corporate goals
- main stress is not on 'how much' but 'why' department needs to spend it.

→ **Budget**

a plan relating to a definite future period of time expressed in monetary and quantitative terms.

Budgets

- On the basis of function and scope
  - Functional Budgets
    - → Sales
    - → Production
    - → Raw Material Consumption
    - → Raw Material Purchase
    - → Overhead
    - → Cash
  - Master Budget
- On the basis of flexibility
  - Fixed Budget
  - Flexible Budget

__/__/____

Functional Budgets: A budget which relates to a function

→ **Sales Budget**:

- most important and most difficult to prepare
- it is important ~~that~~ as if sales figure is incorrect, then all other budgets will be affected.
- difficult to prepare as it is not easy to estimate consumer demands, specially when new product launched.
- It is a statement of planned sales in terms of quantity and value
- forecasts what company can expect to sell to its customers during the budget period.
- prepared to show classified according to products, salesmen, customers, territories and periods.

Factors for Forecasting:

i) Past Sales: Analysis of the past sales shows the trends or any seasonal or cyclical fluctuations which helps in suggesting future trends.

ii) Reports by Salesmen: As salesmen are in direct contact with the market they are required to prepare detailed estimates of sales they are expected to make in their respective area during the budget period which should be further analyzed.

iii) Company Conditions: Any changes in policies and methods of the company and their effects on sales should be considered. eg: additional spending on advertising or introduction of new products should have some effect on sales budget.

__/__/__

iv) Business Conditions: Any changes in economic conditions and in related business activities and their effect on company sales should be considered. Information of the competitors ~~should~~ should be obtained to assess their strength and customers' requirements to determine their demand.

v) Special Conditions: While preparing sales forecast, any new external developments taking place are also considered. eg: a tyre manufacturer would estimate the sales of cars and scooters on which their tyres are used.

vi) Market Analysis: Some companies depend upon market analysis and research to measure the potential demand for their products which reveals the state of market, fashion trends, type of products design required and other factors which may influence the sales of the company.

→ Production Budget:

- It is a plan of production for the budget period.
- Initial step in budgeting manufacturing operations.
- First drawn up in quantities of each product and when the remaining budgets have been compiled and cost of production calculated, the quantities of production cost

are translated into monetary terms.

Principal Considerations:

i) Sales budget: When sales is the principal factor, the production budget will be based on the volumes of sales forecast by the sales budget.

ii) Inventory Policy: Management decision regarding quantities needed in stock at all times to meet customer requirements is an important factor for which factors like storage facilities, risk of price changes etc. have to be given due consideration.

iii) Production Capacity: Production capacity of each department should be worked out and budget figures should be within the limits. Although if production capacity falls short additional machinery and plant can be purchased or overtime working can be introduced and many more methods.

iv) Management Policy: Production policy of management plays an important role in budgeting production. e.g: management may decide to import a particular component instead of manufacturing it which will influence the production budget.

__/__/___

→ Raw Material Consumption Budget

- It is a financial plan that estimates and tracks the consumption of raw materials in a given period, typically within a manufacturing or production process.

- quantity of raw materials required and associated costs based on anticipated production levels.

- business can effectively manage their raw material inventory, optimize production process, control costs and ensure availability of necessary materials.

→ Raw Material Purchase Budget

- It is a financial plan that outlines the expected purchase of raw materials within a specific period, typically for a manufacturing or production operation.
- plan purchases and enter into long term contracts.
- estimates the quantity and cost of raw materials that a company needs to procure to meet its production targets and maintain adequate inventory levels.
- record prices on which budget plan is based
- It indicates the quantities of each type of raw material to be purchased, its timing and the estimated cost.

__/__/___

Factors:

i) opening and closing stocks to be maintained
ii) max and min stock quantities
iii) economic order quantities
iv) financial resources available
v) Purchase order placed earlier and delivery will be received during current period
vi) maintaining record of components to be manufactured separate from that to be purchased.

→ Overheads Budget

- It represents the forecast of all the overheads (fixed, variable, semi-variable) to be incurred during the budget period.
- involves preparation of overheads budgets for each department of the factory as it is desirable to have estimates of overheads prepared by those individuals who have the responsibility for incurring them.

Factors:

i) Classification of all overhead costs into fixed and variable elements. In case of semi-variable items, degree of variability should be ascertained.
ii) level of activity likely to be achieved during budget period like units of output, labour hours etc.

iii) Policy of management regarding matters like overtime work, number of shifts to be worked etc.
iv) Individual items of cost incurred in past.

→ **Cash Budget**

- most important and prepared at last
- detailed cash receipts and payment for all sources and resultant cash balances during the budget period.
- ensures that business has sufficient cash as and when need arises.
- establishes sound basis for credit
- shows whether capital expenditure may be financed internally.

Preparation

- Receipts and Payments Method is usually used for short-term cash forecast.
- Cash budget begins with opening balance of cash and bank.
- Add all cash receipts and deduct all cash payments whether on capital or revenue account and result figure is closing cash Balance.

__/__/__

Master Budget

- All the functional budgets once prepared are summarized into master budget.
- consolidated summary of all functional budgets.
- It ~~has~~ has two parts: (i) operating budget i.e. budgeted profit and loss account.
  (ii) financial budget i.e. budgeted balance sheet.
- Prepared by budget director

Fixed and Flexible Budgets

→ **Fixed**

- Budget designed to remain unchanged irrespective of the level of activity attained.
- If actual differs from budgeted output variance arises.
- Not suitable in those situations where sales and output cannot be accurately estimated.

→ **Flexible**

- Budget designed to change in relation to the level of activity attained.
- Principle is that a budget is of little use unless cost and revenue are related to the actual volume of production.
- developed with the objective of changing the budget figures to correspond with actual output.

__/__/__

- Prepared for various levels of activity say 70%, 80%, 90% and can be compared with an appropriate level, whatever achieved.
- Prepared where it is extremely difficult to forecast output and sales with accuracy. Such things happen when:
  - nature of business when sales are diff. to predict eg: demand for luxury goods
  - sales are affected by weather eg: woollen garments
  - sales affected by change in fashion eg: readymade garments
  - company frequently introduces new products
  - large portion of output is for exports
- Figures are adaptable to any given set of operating conditions, so more realistic
- Useful from control point of view, actual performance should be compared with what we should have achieved in actual circumstances and not not under quite different circumstances.

<u>Preparation</u>

- necessitates the analysis of all costs into fixed and variable, it is imp. coz varying levels of output are considered and each class of overhead will be diff. for each level.
- When computing fixed cost at various levels, fixed cost in total amount remains unchanged at various levels of activity. Fixed cost per unit decreases when level of output increases.

- Total variable cost increases in proportion to increase in the level of activity although per unit cost does not change with level of activity.
- Semi-Variable cost should be separated into fixed and variable components.