Module 14: Budgeting
Lecture 1: Budgeting

Objectives
In this lecture you will learn the following
- Introduction.
- Objectives.
- Advantages.
- Components of Budgetary Control System.
- Types of Budget.
- Zero Base Budgeting.

Budget
Budget refers to an estimated statement. It is prepared by companies as well as government. It is for the purpose of attaining some goal.

Budget can be defined 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. It is often used for control purpose.

Budgetary Control
It is a process in which budget is set and actual is compared with budget to analyse variances.

It means the establishment of budgets relating the responsibilities of executives to the prerequisite of policy and the continuous evaluation of actual with budgeted results either to secure by individual action the objective of that policy or to provide a base for its revision.

Objectives of Budget
- Planning:
  A set of targets/goals is often essential to lead and focus individual and group actions. Planning not only motivates the employees but also improves overall decision making.
- Directing:
  Business is very complex and requires more formal direction and coordination. Once the budgets are in place they can be used to direct and coordinate operations in order to achieve the stated targets.
- Controlling:
  The actual performance can be compared with the planned targets. This provides prompt feedback about performance. Budget also prevents unplanned adhoc expenditure.

Advantages of Budgetary Control System
- Enables the managers/administrators to conduct activities in efficient manner.
- Provides yardstick for measuring and evaluating the performance of individuals and their departments.
- Reveals the deviations, from the budget by comparing with actuals; Helps in prompt review process.
- Creates suitable conditions for the implementation of standard costing system.
- Acts as systematic base for framing future policies and targets.
- Inculcates the feeling of cost consciousness and goal orientation.
- Leads to effective utilization of various resources, as the activities are planned and executed effectively.

Components of Budgetary Control System
The policy of a business for a defined period is represented by the master budget, the details of which are given in a number of individual budgets called functional budgets. These functional budgets are broadly grouped as physical, cost and profit budgets.

- **Physical Budgets** - Those budgets which contain information in terms of physical units about sales, production etc. for example, quantity of sales, quantity of production, inventories and manpower budgets are physical budgets.
- **Cost budgets** - Budgets which provide cost information in respect of manufacturing, selling, administration etc. for example, manufacturing cost, selling cost, administration cost and research and development cost budgets are cost budgets.
- **Profit budgets** - Budgets which enable in the ascertainment of profit, for example, sales budget, profit and loss budget, etc.

**Types of Budget**
- Fixed Budget.
- Flexible Budget.
- Master Budget.
- Functional Budget.
- Long Term Budget.
- Short Term Budget.
- Current Budget.

**Fixed Budget**
A fixed budget is the budget designed to remain unchanged irrespective of level of activity actually attained. Such budget is suitable for Fixed Expenses. It is also known as Static budget.

A fixed budget is not suitable in dynamic environment and for a longer period because of its rigidity. It is not suitable where labour cost, material cost and other factors are constantly changing.

**Flexible Budget**
Flexible budget show the expected results of responsibility centre for several activity level. Flexible budget is the series of static budgets for different level of activity.

While preparing flexible budget the revenues and expenses are classified into Fixed, Variable and Semi-variable categories.

In most cases, the level of activity during the period varies from period to period due to change in demand or seasonal nature or changing circumstances. In such industries/ government organisations flexible budget is suitable.

**Functional Budget**
Budgets which relate to the individual function/task in an organisation are known as Functional Budgets. For example, purchase budget, sales budget, production budget, plant utilization budget, cash budget.

**Master Budget**
It is a consolidated summary of the various functional budgets. It is based on goals set. It serves as the basis upon which budgeted P & L A/c and forecasted Balance Sheet are built up.

**Long-Term Budget**
The budget which are prepared for periods longer than a year are called long-term budget. Such budgets are helpful in business forecasting and strategic planning. E.g. Capital expenditure budget, Research and Development budget.

**Short-Term Budget**
Budgets which are prepared for periods less than a year are known as short term budgets. E.g. Cash Budget. Such budgets are prepared regular comparison and action to bring variation under control.

**Current Budget**
A budget which is established for use over a short period of time and is related to the current conditions is called current budget.
**Zero Base Budgeting (ZBB)**

It refers to budgeting from scratch.

ZBB is a method of budgeting which requires each cost element to be specifically justified, as though the activities to which the budget relates were being undertaken for the first time.

- To receive funding during budgeting process, each activity must be justified in terms of continued usefulness.
- Under ZBB, the budget for virtually every activity is initially set to zero.

**Advantages**

- Provides a systematic approach for evaluation of different activities and ranks them in order of preference for allocation of scarce resources.
- Ensures that the every activity/ function undertaken is critical for the achievement of objectives.
- Provides an opportunity to allocate resources for various activities / functions only after having a thorough cost benefit analysis.
- Wasteful expenditure can be easily identified and eliminated.

**Ex. Material purchase budget**

- Calculate the raw material required to be purchased:
  - Budgeted sales: 5000 units
  - stock of finished stock in hand is 500 units
  - Material A and B units (per finished stock unit) : 12 and 10 respectively

  Opening stock of Raw material in hand
  - A: 5000 units
  - B: 3500 units

  Closing stock of 1000 units of finished goods is required to maintain.

**Solution**

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Budgeted Sales</strong></td>
<td>5000</td>
<td></td>
</tr>
<tr>
<td>+ Desired Closing Stock</td>
<td>1000</td>
<td></td>
</tr>
<tr>
<td><strong>Total Requirement of finished stock</strong></td>
<td>6000</td>
<td></td>
</tr>
<tr>
<td>- Opening Stock</td>
<td>(500)</td>
<td></td>
</tr>
<tr>
<td><strong>Units to be produced</strong></td>
<td>5500</td>
<td></td>
</tr>
<tr>
<td><strong>Raw Material A</strong></td>
<td>66000</td>
<td></td>
</tr>
<tr>
<td>5500 x 12</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5500 x 10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Opening Stock</td>
<td>(5000)</td>
<td>(3500)</td>
</tr>
<tr>
<td><strong>Total requirement of raw material</strong></td>
<td>61000</td>
<td>51500</td>
</tr>
</tbody>
</table>

There is no need to keep stock of raw material in hand, hence company will have to purchase 61000 units of material A and 51500 units of material B.