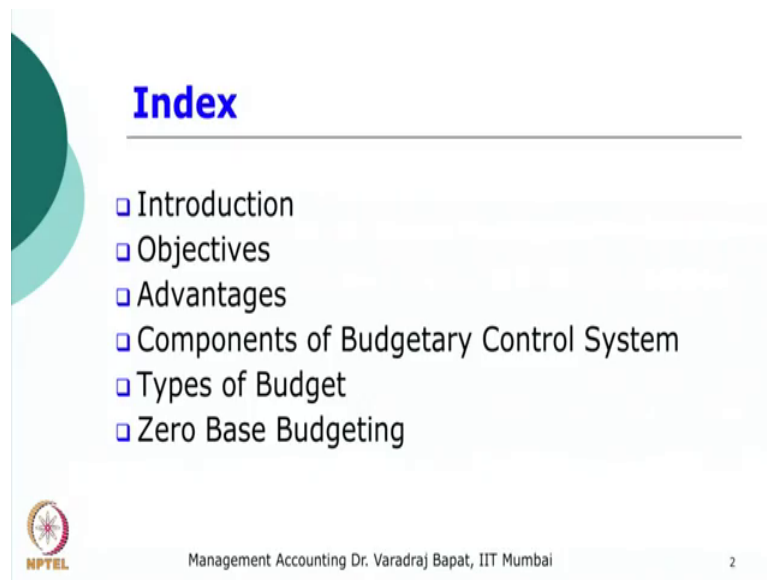


Cost Accounting
Prof. Varadraj Bapat
School of Management
Indian Institute of Technology, Bombay

Lecture - 15
Budgeting and Budgetary Control

[FL] In last few sessions, we have discussed CVP, marginal costing. We have also done several cases involving different types of decisions like product mix then we have also seen many cases involving projections. Today, we will go to next very interesting topic that is on Budgeting, sometimes called as Budgetary Control.

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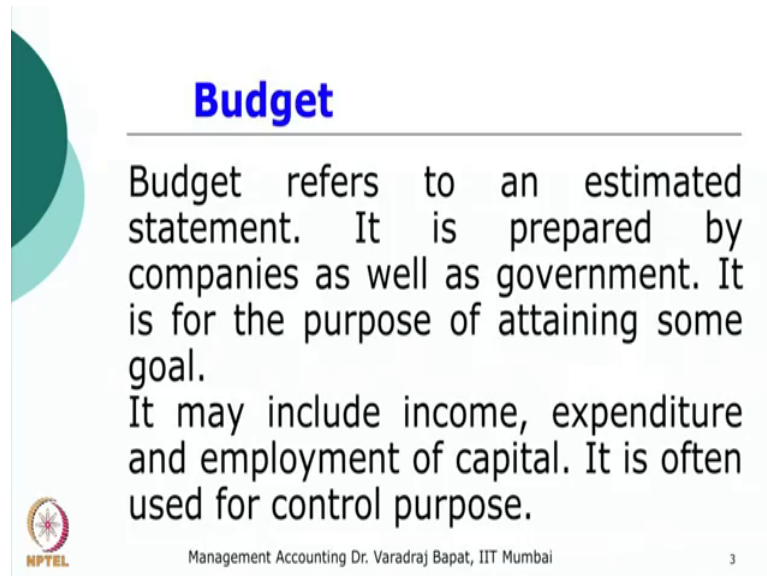
This is the brief index of the topic we will talk about introduction, objectives, advantages, components and different types of budgets and this then about zero base budgeting system. I think most of you would have heard about budgets either about the union budget which is presented by the finance minister or those who are working you would have heard about budgets made in your own company.

So, this budget is one of the techniques of cost and management accounting which has a vast applicability and today it has become very popular technique and used in almost all walks of life. It is used by corporations, by NGOs, by government organizations on a extensive scale and it has become useful as a planning tool as a control tool and as also

the decision making tool that is a very interesting part. We have seen techniques like BEP or CVP then PV ratio most of them are useful for decision making.

There are some techniques like standard costing which are mostly useful for control purposes, but budgetary control is a very unique technique. It is useful both in control mainly it is meant for control, but it is also useful in decision making and as I have told earlier it is useful in several walks of life. Let us talk a little more about budget.


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Budget

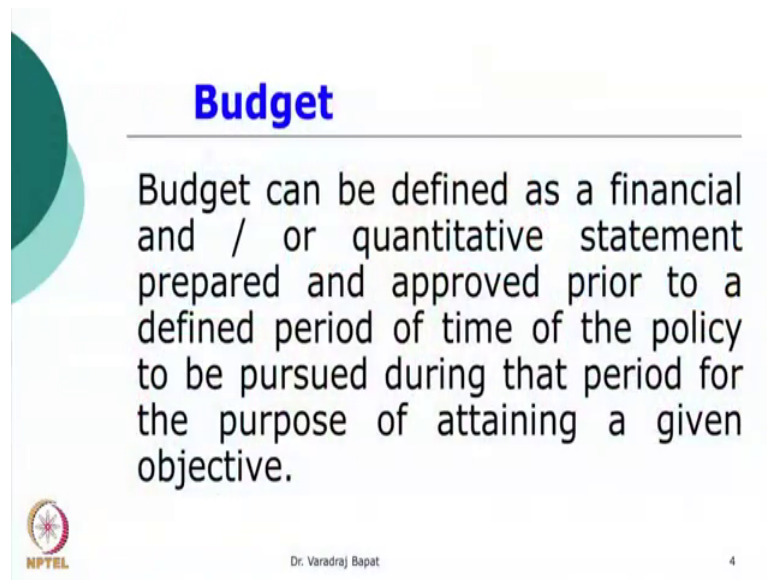
Budget refers to an estimated statement. It is prepared by companies as well as government. It is for the purpose of attaining some goal.

It may include income, expenditure and employment of capital. It is often used for control purpose.

 Management Accounting Dr. Varadraj Bapat, IIT Mumbai 3


First of all you all know that budget is an estimated statement. Budget is always prepared for the next period. So, it sets a kind of goal for you the intention of budget is to achieve certain goal and you can make variety of budgets since we are talking about cost you may feel that budgets are mainly for cost, but they can also be for income or for employment of capital that is investment purposes and they are mainly used for control, for setting up a standard and then we can record the actual and compare it with the given budget or a preset budget.

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Budget

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.

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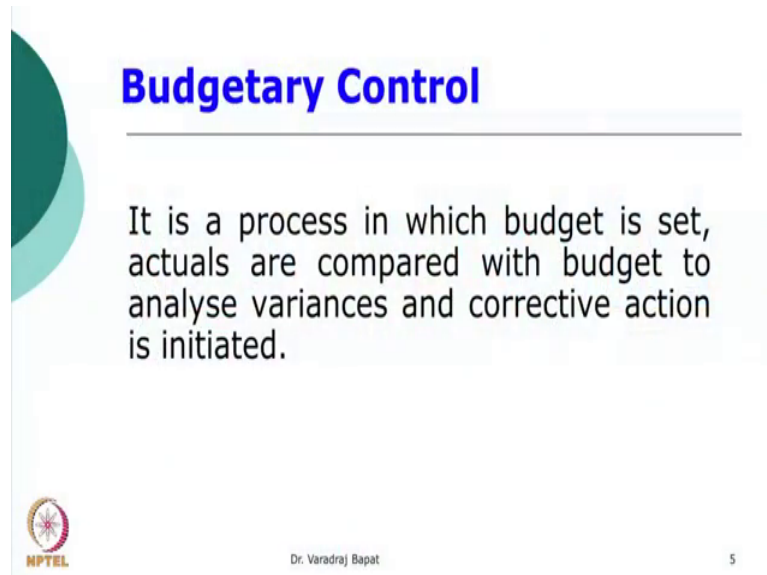
Now, this is a definition of budget that it can be define as a financial or quantitative statement prepared and approved prior to a defined period of time of policy to be pursued during that purpose for attending a given objective.

So, if I say that tomorrow it is likely to rain, is it a budget? It can be considered as an estimate, but it is not a budget for several reasons because there is no particular task we are doing to make that rain happen, neither it is a quantitative measure. But, if I say that it is likely to rain 20 centimeters, will it be a budget? Still not. Yes, now it is a quantitative statement. It is a made prior to the happening, but it is not related to any particular purpose. Suppose, you as students decide that we want to get 95 percent score in a particular course, will it be a budget? It can be provided it is your goal and there is a policy to achieve it like that for a corporate, for a business, for a government everybody uses this technique for achieving certain targets.

Suppose, a sales manager says that now we are working very hard and the sales are likely to increase substantially in the next month, will it be a budget? There is a policy, there is a effort to increase the sales still it is not budget because it is not a quantitative statement. Just by saying it will increase substantially does not make it a budget suppose the person says that our sales will increase by 80 percent then you can qualify it as a budget, but just if you say the sales will increase by 80 percent still it is not a budget. One has to say that


the sales will increase by 80 percent in coming month in comparison to last because there has to be a define period of time and a policy persuaded to achieve that code.

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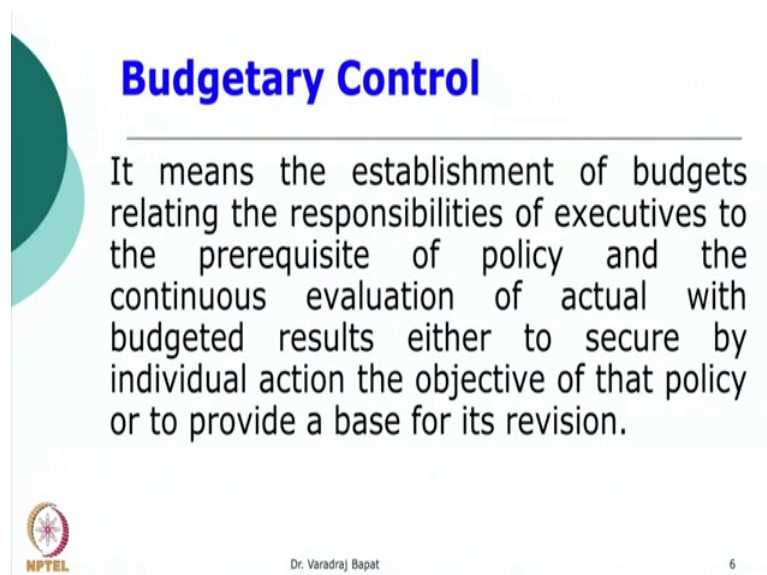
Budgetary Control

It is a process in which budget is set, actuals are compared with budget to analyse variances and corrective action is initiated.

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Now, budgetary control because only setting up of budget is not enough. You have to record the actual, compare the actuals with budget, arrive at variances and take corrective action. All this together is considered as budgetary control.

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Budgetary Control

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.

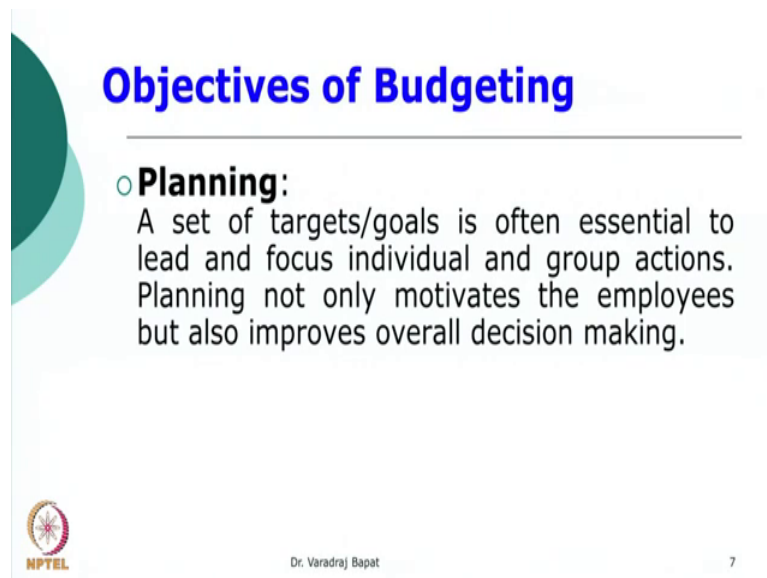
 Dr. Varadraj Bapat 6

So, budgetary control is a mean it what it means is there is a establishment of budget wherein you fix the responsibilities of certain executives because if a goal is to be

achieved it needs to be broken down one should know what an individual department should do within that department what responsible person or a leader is to be is supposed to do, all this would be broken down.


So, budgeted results are either to be secured by individual action or there should be at least a base for its revision, then a proper process of budgetary control will be achieved.

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Objectives of Budgeting


- **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.

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Now, the objectives of budget first objective and the primary objective is planning because budget is essentially a plan it is a set of targets or goal which is often essential to lead and focus individual and group actions because as long as the goals are not set correctly our actions are not focused in that direction. What budget ensures is a period is define and the goal is define and is put down in the quantitative terms.

So, planning not only motivates the employees, it also improves overall decision making. So, the whole planning process is substantially improved if it is a part of budgeting. So, that is the primary objective of budgeting, but budgeting does not stop there.

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- **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.




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The next is directing. Now, business is very complex and it requires a formal direction and coordination. So, if the formal final goal is to be achieved what is required is the resources are properly channelized. We are having different departments or different function. So, in the budgeting exercise coordination is done for each function and accordingly the directions are given to that respective function so that individual departments goals are also achieved and the final goal is also achieved.

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- **Controlling:**
The actual performance can be compared with the planned targets. This provides prompt feedback about performance. budget also prevents unplanned adhoc expenditure.



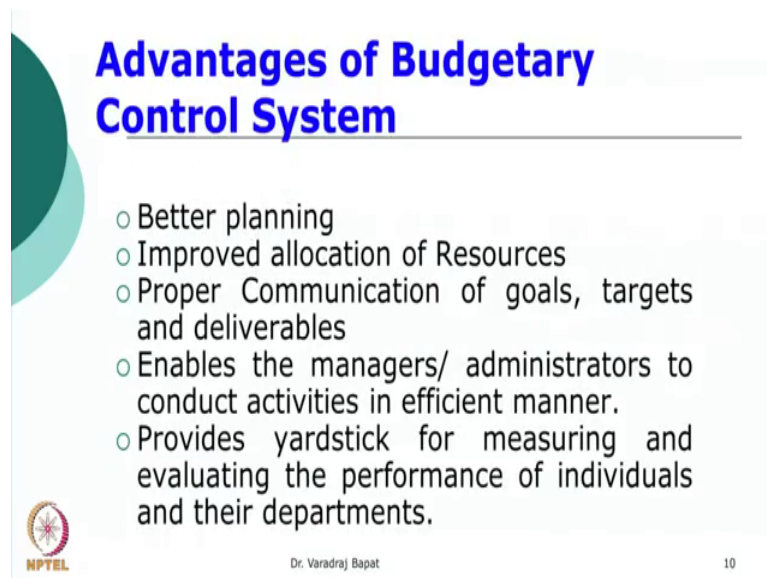
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The third one is controlling. So, we have done planning, we have done directing. Now, the actual performance will be recorded and that will be continuously compared with the budgeted performance so that a feedback mechanism is developed. If we are able to achieve our goals good, we will try to continue our efforts or increase our efforts to achieve further; if we are not able to achieve goals we need to do some corrective action.

So, our efforts will be accordingly revised and in an emergency situation where we feel that it is impossible to achieve the results, we will revise the budget. All this will be a part of control mechanism. So, these three are the major objectives planning directing and controlling.

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Advantages of Budgetary Control System

- Better planning
- Improved allocation of Resources
- Proper Communication of goals, targets and deliverables
- Enables the managers/ administrators to conduct activities in efficient manner.
- Provides yardstick for measuring and evaluating the performance of individuals and their departments.

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Now, the advantages of budgetary control system. The first one is better planning. We already seen that planning is the essential and a most important component of budget. A good plan means 50 percent of the work is achieved. Budget ensure that it is in quantitative terms, it is well coordinated.

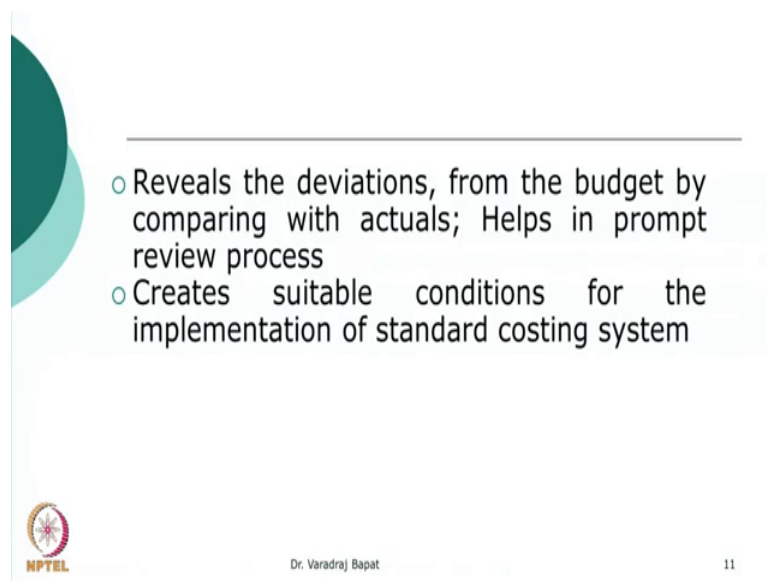
So, much better planning happens in budget. Then, there is improved allocation of resources because each department or each part of the business or each function needs to coordinate their efforts, they should get enough resources. Some of them may be blocking more resources unnecessarily. Budgeting ensure that a proper and a fair allocation happens so that all resources can be channelize for the achievement of final goal.

The third one is proper communication of goals. In absence of budget there will be lack of clarity amongst the departments employees or functions as to what exactly they are suppose to achieve. If everybody just say that achieve the best, achieve as much as possible it does not give a proper communication of the goals and targets. In budgeting whatever is to be finally, achieved gets broken down and every person in the system knows the target or the deliverables properly. So, it serves as a proper communication.


The next one is it enables the managers to conduct the activities in efficient manner because now they know what is to be achieved. So, their activities can be channelize to achieve that. There will not be any half heartedness whether it is more efforts being put or less efforts being put because now the now the efforts being put would be in a efficient manner.

Next one will be it provides the yardstick because having done the good planning you will record the actuals. Now, always there will be feeling amongst the employees that they have achieved their best, whether it is good enough or not remains subjective as long as you have got well defined goals. In budget what happens the deliverables are well defined. So, one can measure and evaluate the performance in a very objective manner. It serves as a very good yardstick for objective evaluation of performance.

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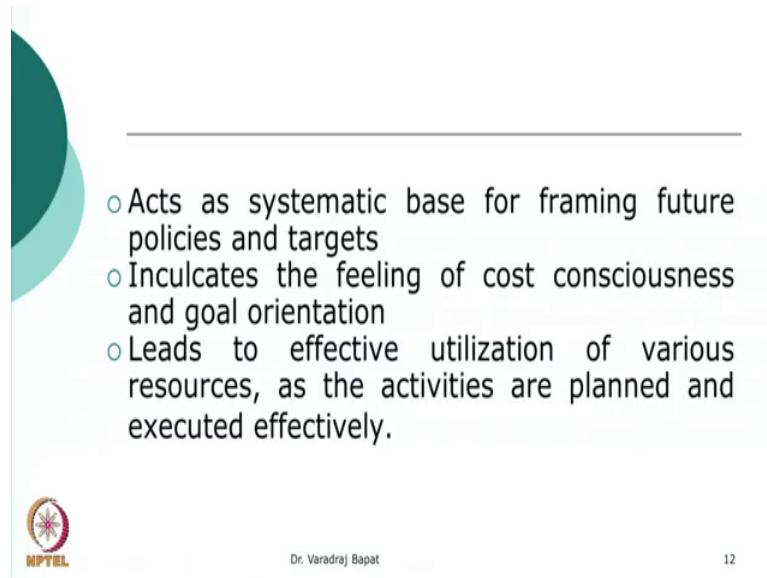
- Reveals the deviations, from the budget by comparing with actuals; Helps in prompt review process
- Creates suitable conditions for the implementation of standard costing system

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Then it reveals the deviations. So, as soon as the actual data is available it can be compared. One can know whether you are achieving or not achieving and that helps in

prompt review process because if the goals are being achieved you can continue your efforts, if the goals are not being achieved corrective measures can be taken without too much of delay. And, the last point is it creates suitable conditions for implementation of standard costing system because with the help of budget you can create standards which can serve as objective targets for employees and the departments.

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- 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.

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The next point is budget acts as a systematic base for framing future policies and targets because current year budget usually becomes base for next year budget. It inculcates a feeling of cost consciousness because now the targets of costs are known. So, employees will be able to cut down on cost or control their cost and at the same time there will be a goal orientation.

Since the goal is known the efforts we get channelized for the goal and the last point is there is efficient utilization of various resources because planning has been done properly and execution and corrective actions are being taken in a timely manner. So, there is effective utilization of various resources.

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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.

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So, we have seen various advantages of budgetary control system. Now, let us look at the components. Now, policy of the business for a particular period is a master budget that is a budget for the whole company or suppose it is a government budget; it is a budget for the whole government. Then that the master budget is divided or broken down into functional budgets which are budgets for a particular function.

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Types of Budgets

- Fixed Budget Vs. Flexible Budget
- Functional Vs. Master Budget
- Long-Term Vs. Short-Term Budget/ Current Budget
- ZBB

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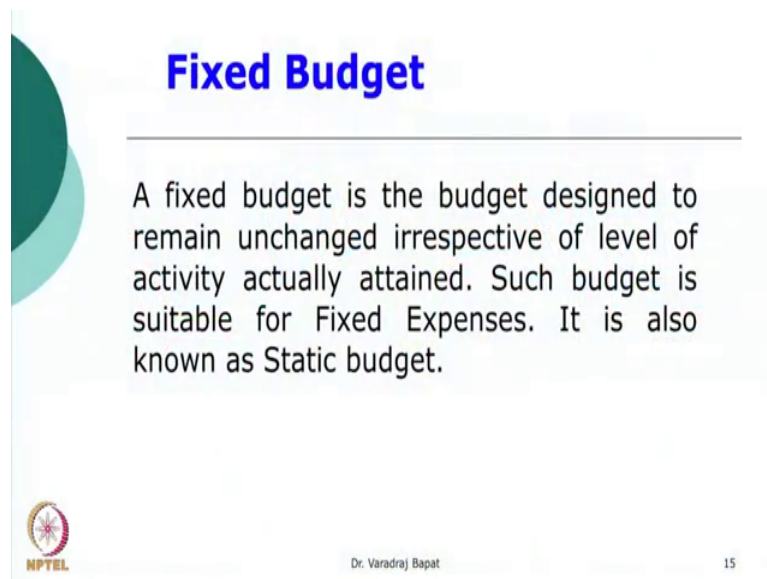
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These are the various types of budgets. It can be segregated as fixed versus flexible; functional versus master; long term versus short term and the last type is zero base budget.

So, the first type is fixed versus flexible budget. Now, what do you understand by fixed budget? I think the name is self explanatory by name itself you will be able to imagine what would be fixed. Here the assumptions are fixed and there is a certain level of possibility of something is happening.


Based on that you will work out on a budget and there will not be much chance of deviation from it whereas, in a flexible budget you are assuming a dynamic scenario where the assumptions are likely to change, the markets are likely to substantially change, the level of activity is likely to change accordingly the budget is so designed that you can have a budget for various levels ok.

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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.

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So, fixed budget it is designed to be unchanged. It does not give much importance to level of activity. Now, this is more useful for fixed cost.

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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.

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Now, it is not useful for a dynamic scenario because if your labour material cost are your major cost as per the level of change of sales units those costs are likely to change. So, there the fixed budget does not become very much suitable.

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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.

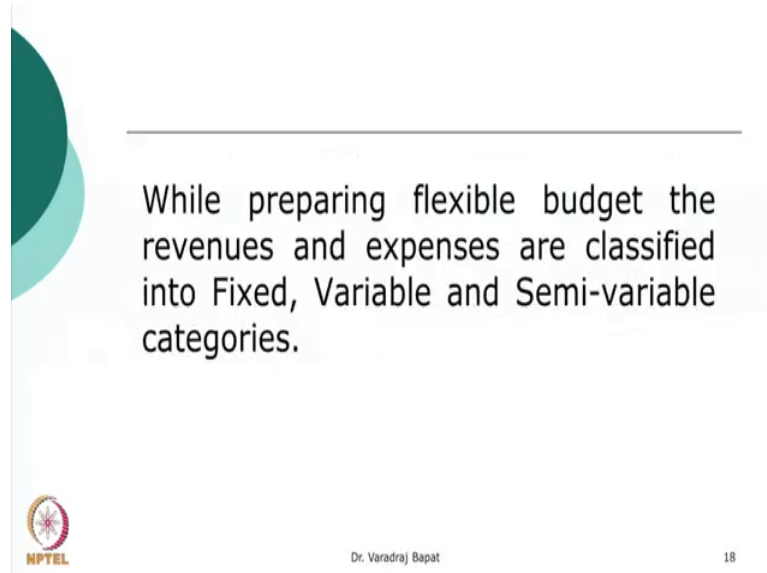
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Now, the solution to this problem is flexible budget. Now, flexible budget show the expected result of responsibility center for several levels of activities. So, instead of saying that you will achieve 1000 unit; so, these are the cost, you will say that if 1000 units is a sales these are the cost. If 1100 these are the cost, if 1200 these are the cost. So,

you will make various possible columns and that is of the flexible budget is structured. It is a series of static budgets.

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

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Now, for making flexible budget it is necessary to classify the cost into fixed, variable and same variable because now you are looking for different possible levels of activities and the costs are going to change as per different levels of activities. Now, normally there will be change in the number of units from period to period.

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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.

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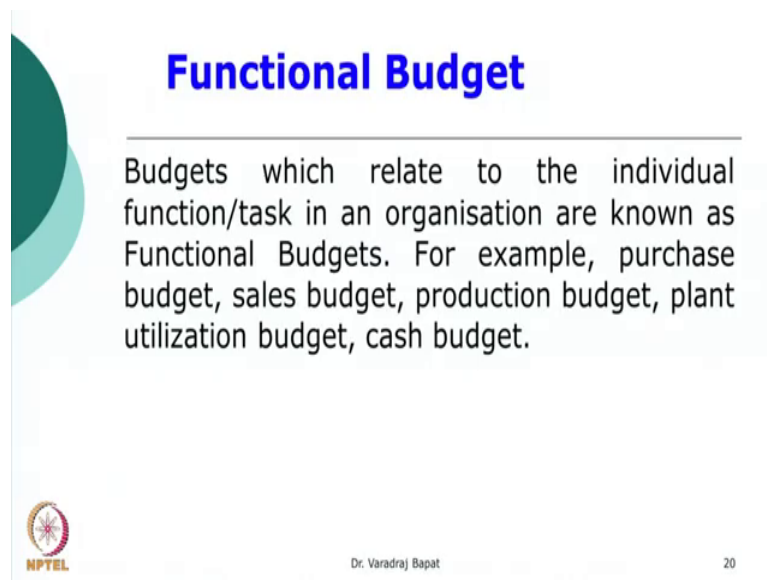
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So, flexible budgets are more useful in various commercial organizations. However, for certain industries or for government organizations as per the need of the scenario the targets will change. So, there also the flexible budgets are quite useful.

Now, the second type of classification that is with respect to functions. Now, the master budget is broken down as per each function and we will prepare a budget for each function that will be known as a functional budget. For example, you will have a purchase budget for purchase department that will specify how many units of which item and at what rate, what will be the total cost. So, such types of purchase budgets will be developed for each week or for each month and so on.


Then there will be a sales budget. So, marketing team will estimate the likely sales, they will break it down into product lines sale units the likely prices which will be received or recovered. So, there will be a sales budget, similarly there can be a production budget, plant utilization budget, cash budget and so on. Do you think of any other budget than what is specified in the slide?.

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Functional Budget

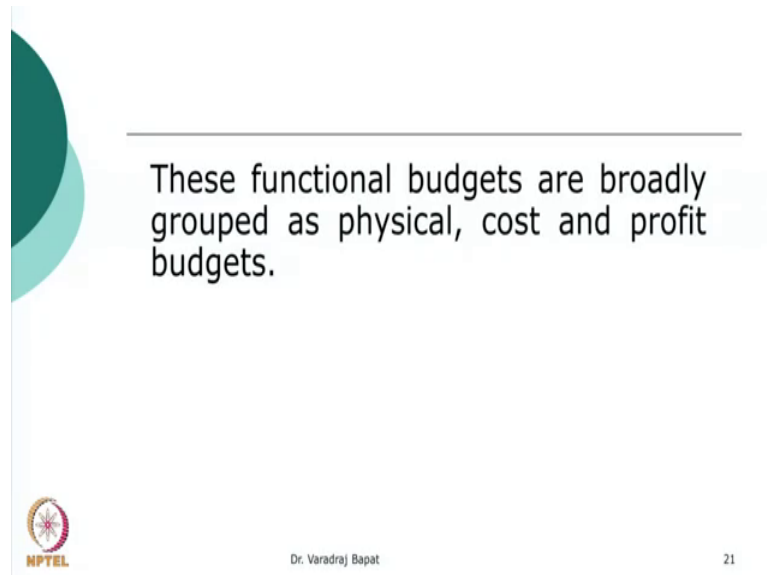
Budgets which relate to the individual function/task in an organisation are known as Functional Budgets. For example, purchase budget, sales budget, production budget, plant utilization budget, cash budget.

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For example, if you are in a manufacturing industry there will be a factory cost budget or you can have a advertise advertisement expense budget, you can have a R and D budget. There is low limit. For each function in which an organization is operating you will make a separate budget for the function. When I said separate budget it is a part of the whole

budget, but for that particular department a particular portion is given that is known as a functional budget.

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These functional budgets are broadly grouped as physical, cost and profit budgets.

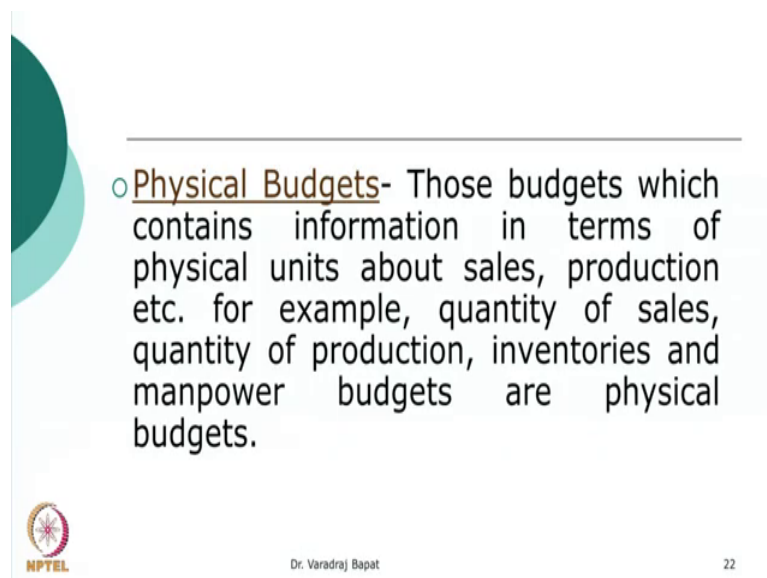
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Now, these budgets can in turn be grouped as physical budgets, cost budgets and profit budgets.

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o Physical Budgets- Those budgets which contains 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.

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Now, this is a physical budget. As the name suggest it is about the quantities. So, whether it is sales or production or inventories it gives the units of sales, units of production and so on. When it comes to manpower it talks about how many employees are required with

what types of skills, how many works how many hours of work will be done that will be a physical budget.

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o Cost budgets- Budgets which provides 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.

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Then there are cost budgets. Here the total cost is specified. It can be manufacturing cost, admin cost, R and D cost. Those are called as cost budgets.

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o Profit budgets- Budgets which enables in the ascertainment of profit, for example, sales budget, profit and loss budget, etc.

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You also have profit budgets. When you compared the revenue with cost you will get various types of profit budgets.

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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.



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Then there is a master budget. Now, this is a consolidated budget of all functional budgets because each functional budget is intended to be coordinated with each other, so you can make a summary of it. Normally will be presented like a budgeted P and L account and forecasted balance sheet for that particular division department or for the whole company.

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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.

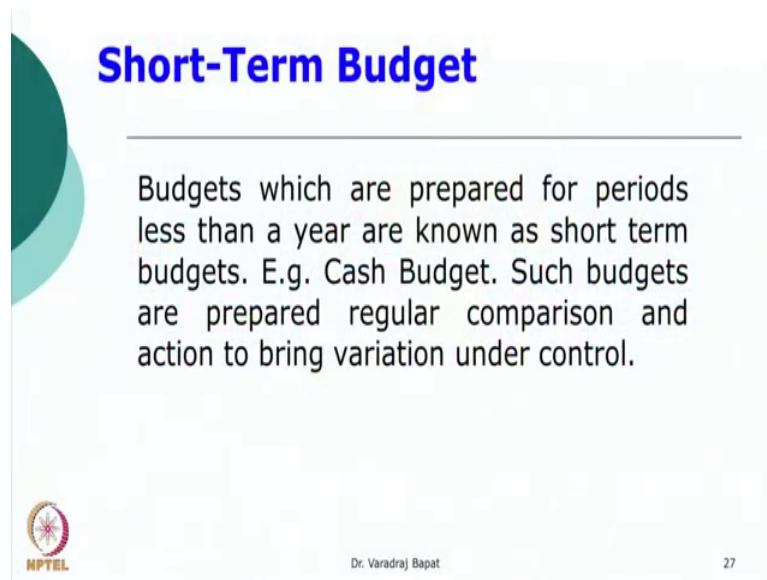


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You can also classify the budgets as per the timeline that will be called as a long term budget. Typically, any budget which is for more than one year is long term. So, the


management at a higher level will do some strategic thinking like what new projects they want to start; what capital expenditure is proposed; what R and D they want to do such types of budgets are normally made for 3 years, 5 years, 10 years for a country it can be even 20 years, 50 years that is called as a long term budget.

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Short-Term Budget

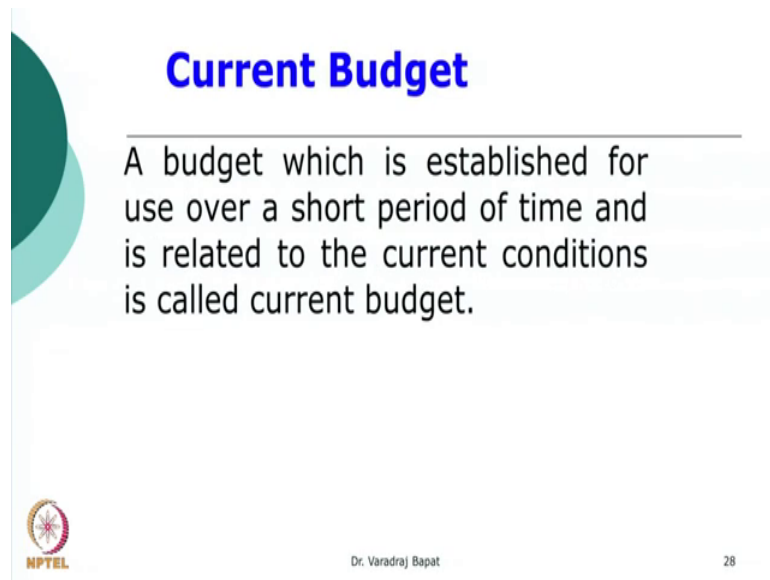
Budgets which are prepared for periods less than a year are known as short term budgets. E.g. Cash Budget. Such budgets are prepared regular comparison and action to bring variation under control.

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Then the long term budget will be divided into short term targets that will be considered as a short term budget. Typically it is prepared for one year or less than one year.


So, budgets like cash budget or production budget or purchase budgets they are typically for much shorter period it can be a 1 year or 3 months and so on.

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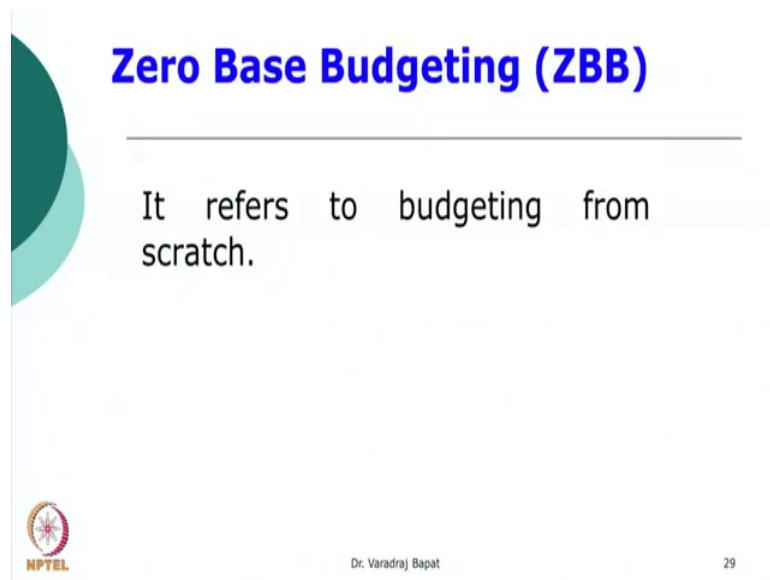
Current Budget

A budget which is established for use over a short period of time and is related to the current conditions is called current budget.

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You can also make a current budget which is even for a shorter time say for a month or for a week that can be called as a current budget.

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Zero Base Budgeting (ZBB)

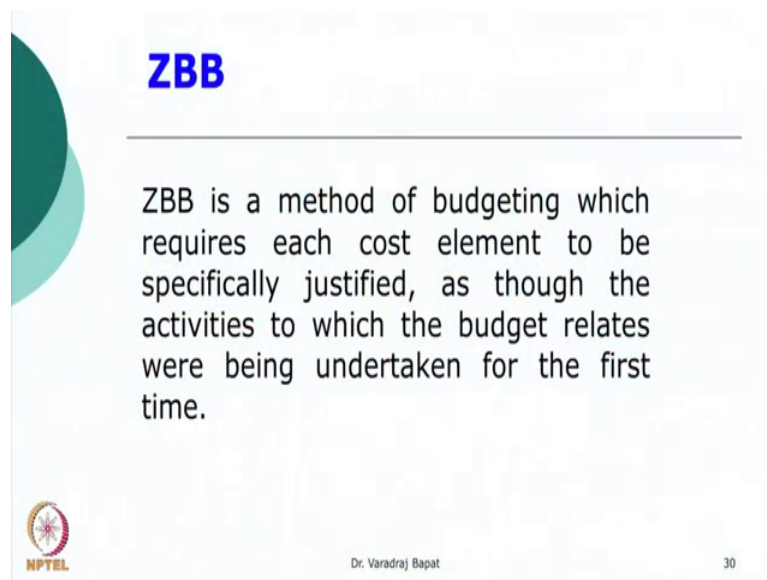
It refers to budgeting from scratch.

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Now, coming to the next important concept in budgeting, that is known as zero base budgeting. Now, as you know most of the budgets are based on the last years or last periods budget. So, when you want to make budget for the current period you will take the last periods budget and then compare that with the current budget ok. So, last periods budget you may add 5 percent, 10 percent, 15 percent as per the change scenario and


make the current budget, but in zero base budget what happens is you start with a scratch. So, you assume that this is the first budget. So, any prior budget will not be accepted unless you are able to justify for the current period that type of system is known as zero base budgeting.

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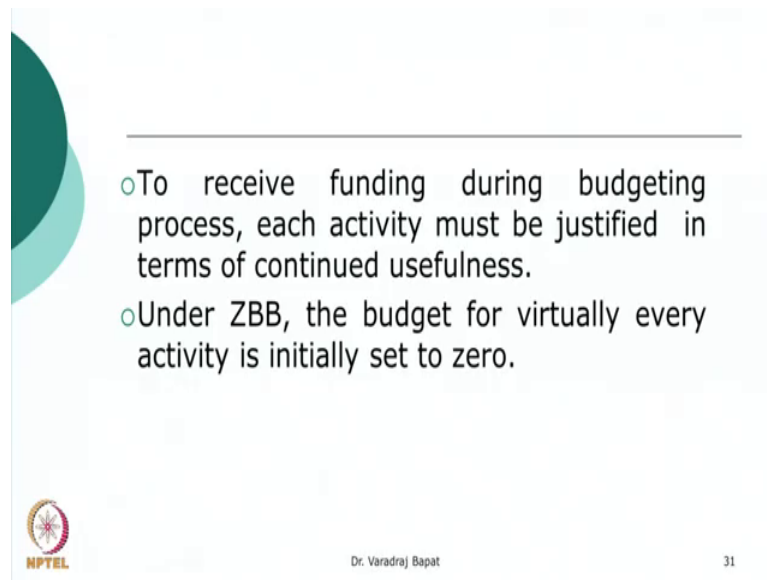
ZBB

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.

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So, this is the formal definition. So, this is a method of budgeting where each cost element or each activity has to be justified afresh. You cannot justify by saying that last year we have done this, so, this year also sanction this money. It will be sanctioned if and only if it is required, it is necessary, it is useful for the current period without considering whether it was sanctioned in the last period or no.

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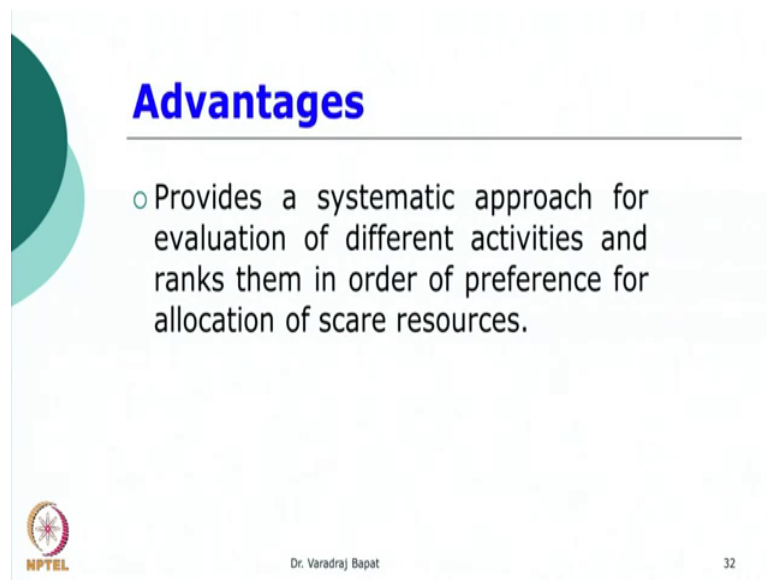
Slide 31 features a decorative teal and light blue circular graphic on the left. The main content area has a light blue background with a white grid. It contains two bullet points, each preceded by a teal circle. The NPTEL logo is in the bottom left, and the slide number '31' is in the bottom right.

- 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.

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So, to receive funding in the current budget process each activity needs to justify itself a fresh. So, every activity has to virtually start from the beginning to justify itself.

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Slide 32 features a decorative teal and light blue circular graphic on the left. The title 'Advantages' is in bold blue text. Below it, a single bullet point is preceded by a teal circle. The NPTEL logo is in the bottom left, and the slide number '32' is in the bottom right.

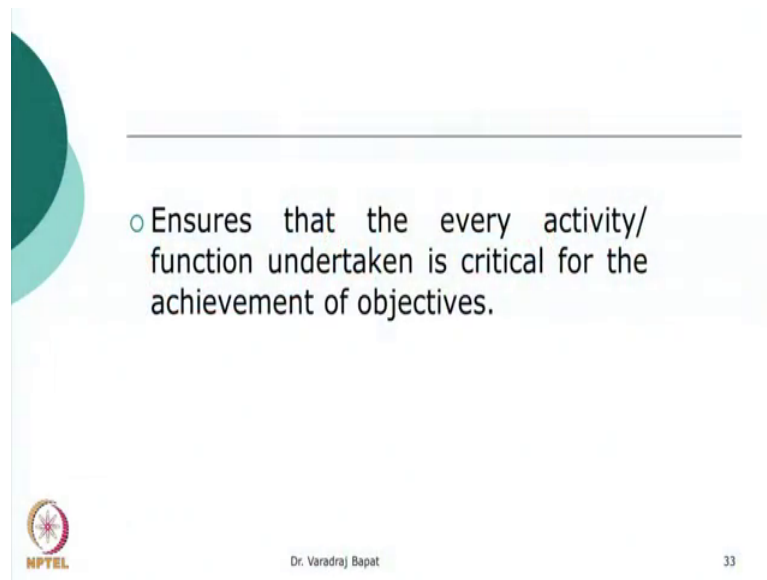
Advantages

- Provides a systematic approach for evaluation of different activities and ranks them in order of preference for allocation of scarce resources.


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Now, there are lot of advantages of zero base budget because this is a very systematic approach where all the activities make their presentations, their rank and as per the order of preference scarce resources are allocated. So, it serves on much better allocation of resources than a traditional budget.

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○ Ensures that the every activity/ function undertaken is critical for the achievement of objectives.

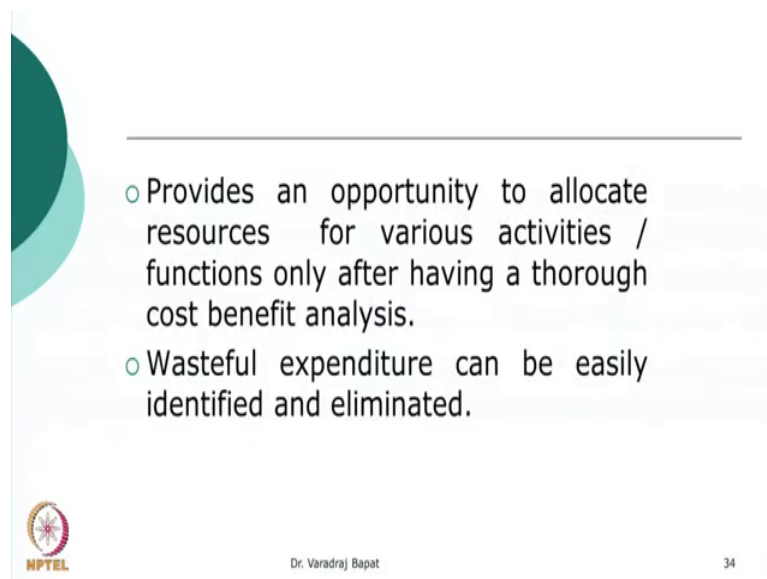
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Now, only the critical activities are taken because of the justification every year.

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○ 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.

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There is an opportunity to reallocate the resource because now the cost benefit analysis will be done every time the resource of the budget will be done. And, lot of wasteful expenditure gets identified. There might be lot of bad would over long period of time you might be incurring certain expenses which are unwanted today, but they just continue because of the traditional budgeting method. In zero base budgeting such expenses are identified and then they can be eliminated.

There are also some problems in zero base budgeting because it is a very much time consuming process. It takes a long time to approve the budget and there maybe lot of people having wasted interest. So, they typically oppose zero budgeting system that is why governments or even organizations find it very difficult to implement ZBB system, but considering the advantages it continues to be a very much useful concept and it can be applied wherever there is a opportunity to have enough time and there is a possibility of proper evaluation. So, we have discussed various concepts of budgets.

With this we will stop here [FL].