Management Accounting
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Lecture 12: Budget and Budgetary Control-1

Welcome students! So, now the next part of discussion will be the budgets and the budgetary control, which is a very important tool and instrument for managing the corporate of years. In the previous classes we learnt the basics of management accounting and the cost sheet or the statement of the cost and learned about that how to the statement of the cost, what is the purpose of the statement of the cost and how this information which is generated by the statement of the cost can be used by the managers for the important decision making.

Now, after the cost sheet; next important instrument for managing the organizations which facilitate the relevant management decision making are the budgets and the budgetary control. Budgets and the budgetary control are the very important instruments tools for again controlling the affairs of the businesses. Because it provides a say roadmap, once we prepared the budgets in advance in provides a say roadmaps. See, in management accounting, the relevance of inference this say deviations, variances is very high.

We plan to do something, we go for execution of particular thing and finally we compare the plan and the executed results and try to find out whether we have been able to achieve but we planned for or we have not been able to, right? So, in this case if the planned targets were high, execution was less than the targeted once in that case there will be variance and that variance will be called as negative variance.

For example, we talk about sales performance, company estimates that in given one months period of time they want to have to retain the sales of say one million rupees, so this was a budget for achieving that target number of means actions were taken, all possible care was taken, all possible attempts were done by the company and at the end of the month, they will now say try to find out what was the level of the sales, what was the quantum of sales.

So, they find out that actually it is not ten lakhs rupees it is only eight lakhs rupees they could sell in the market and serve the market requirements. So, it means 10,000 minus, ten lakhs minus eight lakhs there is a variance of two lakhs rupees and this is called negative variance. Now, if there is a negative variance we will have to find out the reasons for that why this negative variance has come up.

Why this negative variance has come up? There could be many reasons, it may be possible that our target of achieving one million rupees sales was very high it was not attainable, so it means your target was not say achievable and it was not realistic. On the other hand the target was realistic that was achievable but the efforts of the sales force, efforts of the marketing team were not up to the mark or sometimes may be because of some other factors availability of the substitutes in the market.

Sometime availability of the better products then the one in question and at may be sometime at a very competitive price, people tend to shift from the present product to the new product so the new alternatives in the market. So anything is possible. So, we will have to find out that, yes, if there is any negative variance that the target results would high, actual performance is less than that, then we will have to be careful and try to find out why this negative variances come up.

So, how it is possible? First we have to plan for that. First we have to make budgets for everything and then we will go for the execution and then we will have both the results and finally can calculate the difference, now there could be favorable variances also say, for example, we had the target of selling worth rupees one million in the market; in the coming one month, and actually we could sell, we could exceed the target and we could sell one point two millions worth of the goods in the market right?

In that case again if you compare then the there is a variance between the budgeted and the actual results. So it is a variance but a favorable variance or a positive variance but sill it is also not good. We will have to find out the reasons for these favorable variance of two more lakh rupees that more than ten lakh rupees sales we have actually made the sales of twelve lakh rupees, so how could we achieve this target means more than the target we could sell in the market. How was it possible?

Now, because though it is a favorable variance but we should not feel happy that yes there is a favorable variance so we should not worry about and we should simply ignore it. In this case, favorable variance is also equally means questionable as a negative variances. So again the analysis will take place. There could be a reason that whatever the target was that was much less. Selling worth rupees one million as targeted was not means realistic, we had the capability to sell more than that so actually the performance was ought to be more than one million or ten lakh rupees so it has come up.

So it means, when our target was less actual performance is more its shows that there is some defect in our budgetary process. That also has to be done away. Finally, means the budget requires that we will have to set the roadmap, set the agenda, go ahead, start walking on that say roadmap and finally try to achieve the target for that the budgeting process, the budgetary process, budgetary control has to be very-very say nearer to the accurate or the achievable targets so that negative and positive both kind of variances can be avoided right?

Both kind of variances can be avoided that is the very important question here. So we will have to then analyze the variances but here a million dollar question is, is it all the times require to analyze the variances? No, I would say no only thing is that we will have to establish some minimum threshold label. Say we will say that if the variances are 10 percent or more then yes, we will go for the analysis and if it is less than 10 percent we will not analyze the variances they are allowed to happen, that kind of variances are expected to take place.

If it is more than 10 percent, we will establish a cause and effect relationship we will try to find out, so that this kind of the deviations in the targets and the actual performance never appear again. Now, why I am saying that if it is less than 10 percent, it is ignorable, again the basic rule of management accounting that the rule of cost and benefit analysis. If the variance is less than 10 percent, if you start analyzing the variance and try to find out the reasons for that variance whatever the benefits we can derive or attain out of this analysis the cost of making the cost of making this analysis will outsmart the benefits.

So, always we think in the terms of that all the times that whatever actions we take in the process the cost has to be lesser than the benefit and we feel that is going to be possible if the variances are more than 10 percent; then fine, up to 10 percent or below we will not analyze we will see that between the budgeted and actual process this kind of the deviation is expected and is not requiring any kind of analysis right?

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So, now let us understand the budgetary process here in detail by making a point wise analysis and what are the important considerations involved in the budgetary process and how it facilitates the effective decision making by the managers in any organization in any company. Now, here is the question is, why corporates do budgeting? Why budgeting is required?

How it is a effective and useful tool? We have on this side, you can say on this side it is budgets. We are putting a budget and how the budget is facilitating? What the budget is facilitating the goals and objective. So, it means ultimately what is it? It is basically a roadmap. We have now created the roadmap, we have set the goals and the targets, we want to walk on that because once the road is decided, the path is decided map is decided then it is easy to walk on that.

And what happens that once the budgets are already put in place, they remain inform to everybody in the organization, in the firm as a whole and everyone may be the lowest level workers to the top level say person working in the company they remain informed that what is expected to do means from them what is expected, what they are required to do in the organization, what is their contribution, what are their expected responsibilities and duties.

Because that budget instrument means communicated to all the people at all the levels performing all kind of activities, so it means it is very easy, useful for everyone that is why it is called as that the budgeting process is a kind of roadmap which facilitates the goals and objectives of the organizations.

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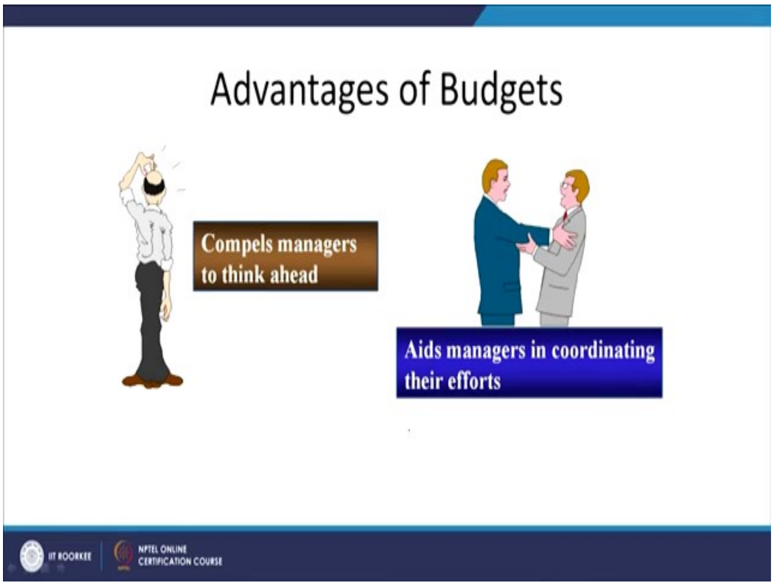

So, in this case we talk about the important points here that advantages of budgets. I told you already what here if you look at the points given that it compels managers to think ahead. What they are going to do that it compels them what they are going to do? How they are going to do? Who is going to perform one particular activity? What is required to be done? So this everything is decided pre decided or decided in advance.

Aids managers in coordinating their efforts: Because everybody is now communicated their role in the organization, in the firm and in the coming one month in coming time horizon, budgeting horizon what is expected from the different people. So since everybody knows it that what are their duties? What are their responsibilities?

What is expected form them in the time, in the coming one month? So in that case they remain coordinator, they remain connected to each other and once everybody is coordinated, once everybody is connected then it is very well it is possible very nicely that organizational objective will be achieved, right?

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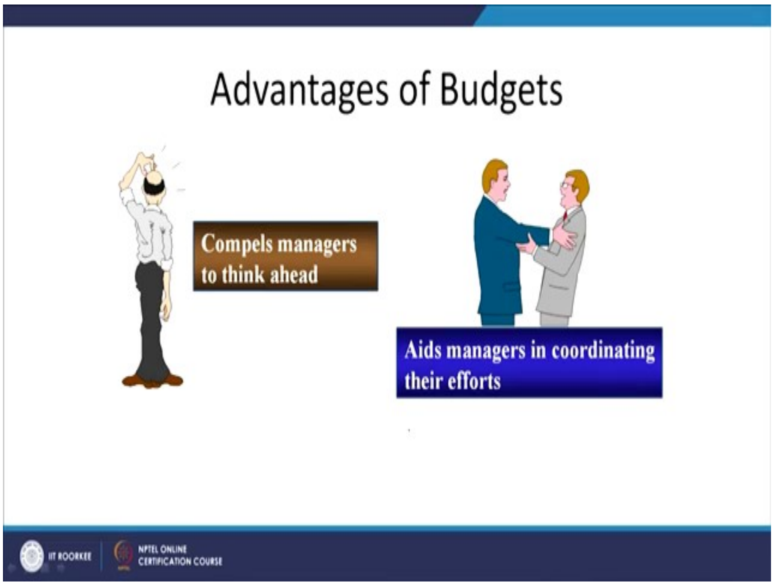

So, third important say advantage is, provides definite expectations that are the best frameworks to evaluate the performance. It is a very important point in budgeting. See if we want to evaluate the performance of somebody, there should be some threshold, there should be some target level, there should be some budget. If that is possible, if you have already set the road map, already have communicated the target to different set of people in the organization in the business firms and now they also know it that after the that the given period of time what is expected from them, it will be evaluated.

So since, they know it what is expected? Since, they know what to do? How to do? So it means in that case the definite expectation are there by the superior from the subordinates working in the firm or the top level, by the top level people form the people working in the different organizations and in this way management decision process becomes very-very easy and useful and you can call it as facilitated. Now, let us talk about the types of the budgets. What different types of budgets we prepared?

You must have heard about that budget is simply a say a document which helps us to pre decide the agenda of that means big things to be done in the time to come, in the period to come and budget is only just budget means we are talking about the types. But here, I will discuss with you that as per the discussion required in this subject or as per the requirement required in this subject or this relevance on the management accounting in a managerial decision making we divide the total budgets into five different budgets.

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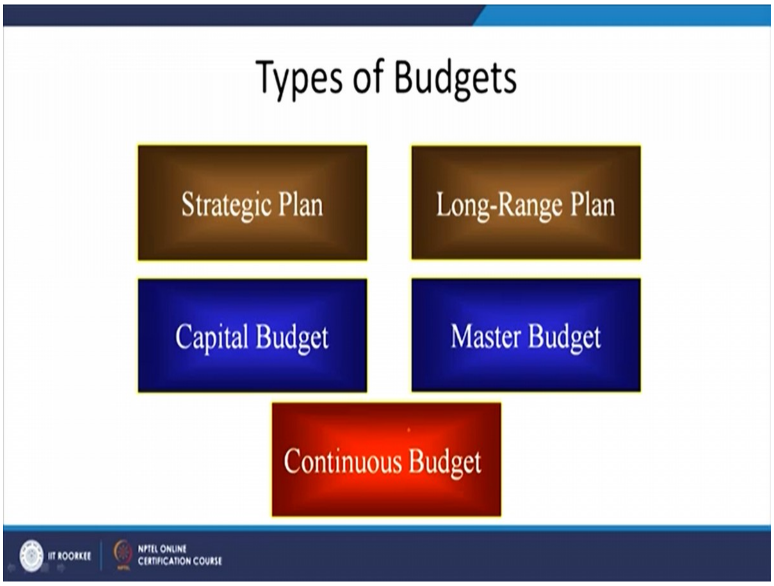

Strategic plan means a very long range plan. Long range plan means it entails a time period of five to ten years. Then a capital budget is about is all about creating the fix assets in the firm or say the long term assets in the firm, how much land we require to create the organization? How much plant building machinery, fix assets, everything has to be properly planned because it depends upon how much production we are accepting from our company or for the given period of time from a given manufacturing process how much production we are accepting, right?

And if that has to be achieved, we should have a minimum plant capacity we should have the say other facilities a say created and for that we need to have the fix assets, long term assets. So capital budgeting deals with the acquiring the long term fix assets in the organizations and accordingly investing the financial resources for acquiring those assets. Master budgets is say basically a budget which is for a specific given period of time which is maximum one year, it can be for six months, it can be for 3 months, it can be for one month also.

Why we call it a master budget, because it includes everything. It includes the operating budgets that how much production we are going to do? How much material is already available is already there in the warehouse we are going to make use of it, for manufacturing the amount of given final output form where the inputs will come? How much inputs are required to be there? How much operating expenses will be there?

So total operating budget we have to, total manufacturing budget we have to set in advance one. Now, once you go for operations in the firm then, automatically it translates into the financial results and financial results can be in terms of the profits or loss from the particular business activity for a given period of time and the impact of those activities that performance on the financial performance of the firm.

So, in this case master budget we call it as a master budget because it includes both the budgets, operating budget as well as the financial budget, the end of the operating budget is by preparing the profit and loss account or income statement. So, we get to know that under operations when the organization was what was the performance of the firm and whether we have resulted into the profit or loss at the end of the period.

And in case of financial budget we only talk about two things that we prepare the cash budget and then we prepare the budgeting balancing budget sheet, so end of the financial budget would be preparing a budget balance sheet end of the operating budget should be preparing a budgeted profit and loss account in between these two we prepare another financial statement which is called as the cash budget, right? So, means why we call it as a master budget because it is most comprehensive budget.

In the strategic plan we decide a long term, very long term objectives under the long range plans time horizon comes to five to ten years and capital budgets are with regard to the acquiring fix assets in the firm. Master budget includes the total performance for the given period of time, operating budget, financial budget, cash budget so that we call it as a master budget and then the continuous budget.

So, I can I can say, for example, our time horizon for the budgeting is say three months, right? Our time horizon is for the budgeting is say three months, and in that three months you cannot say that once have prepared the budget for three months so I will not look back now and I will start performing, to achieve that three months target, again you have to shorten the time horizon that now to achieve those two targets, now you start planning for every week, right?

That is the sub budget of the master budget of three months that in this week how much production is going to take place? How much sales will be there in the market? How much operating expenses are expected to take place? How much raw material is required? And how the sales will be so that when you bifurcate the bigger budgeted targets say for three months or six months or one years to the, the regular budgeting sub budgets process then it is called as what it is called as, what it is called as continuous budgeting system.

To achieve the targets decided under the master budgets we require the continuous budgeting system and if you are going for the continuous budgeting, if you are reducing the time horizon, minimum time horizon for the continuous budgeting is one week. You can have one fortnight also or you can have monthly budgeting also, so to achieve the three months target you again go for the monthly budgeting and then at the end of three months you can find out that whether we have been able to achieve that target or not right? So strategic plan what is written here.

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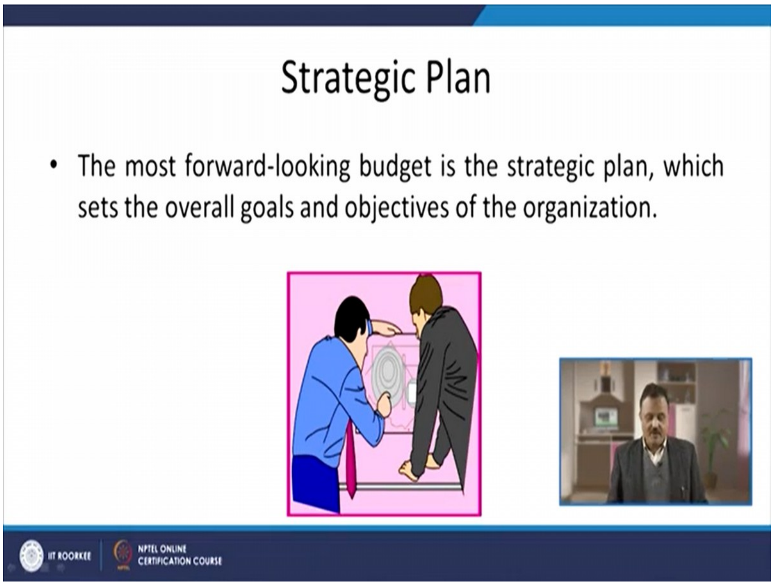

The most forward-looking budget is the strategic plan, which sets the overall goals and the objectives of the organization means when you setup the company the organization for the first time. You start as an individual entrepreneur, or two friends can join together, three friends can join together and then they want to take that organization to some level.

So you have to be a visionary that from have going to start, where you are going to end up for example when Infosys was started by say seven people, at that time it was at very small level but at that time they must have set a strategic plan that we want to start our operations from a very small level and then over a period of time in next fifteen, twenty, thirty years we want to make it as a transnational company.

So, this is a strategic plan looking at the all factors prevailing in the market where you want to start, where you want to end up over a period of fifteen, twenty, thirty years where you want to take this organization. The companies which are transnational companies, multinational companies today one day they were started as a one man organizations but today they have come to the level where you call them the global companies transnational companies and the multinational companies.

So, somebody must have started them may be hundred years back, or may be fifty years back or something like that, for example, now you talk about now the Patanjali. When Baba Ramdev started the business operations or moved into business activities it was at a very small level but, within a few years may be in the previous 5 - 10years period of time this company, this organization become a ten thousand crores group and now they are almost in every area, in every consumer activities into medicine into the say now they are planning to come to the textile also and so many other areas.

So this is the say foresightedness of the, the initial promoters. May be Baba Ramdev have that kind of insight that I want to create a organization which is able to compete which the leading multinational companies like HUL or may be the Nestle or may be the other companies and we would also create a company which will be known as indigenous, Indian company and within a period of next five years period of time we will convert that company means a national company and it may be possible that tomorrow it become the international company or may be a multinational company.

For example, you talk about another company that is Nirma products. Nirma India limited. Now, was started by Karsanbhai Patel in 1982 as a one man organization. He started his operations at a very small level at means at home he started manufacturing the washing powder and then he started means when the concept was workable, product was acceptable to the people, he started growing, growing, growing and today you can say that Nirma is at least a international company. Nirma has manufacturing facility only in India but their products are found even outside India also and now see one man who started this organization as a sole proprietorship in 1982 today say how many years we have 36 years period of time that a company has reached up the horizon that number one.

Geographically it has become a wide spread organization and second thing now they have diversified, they are into the consumer sector, they are into say education sector, they are now into the other areas also. So this is a vision, so strategic plan makes this all possible that you have to set the target which you want to achieve in the next fifteen, twenty, thirty years, right?

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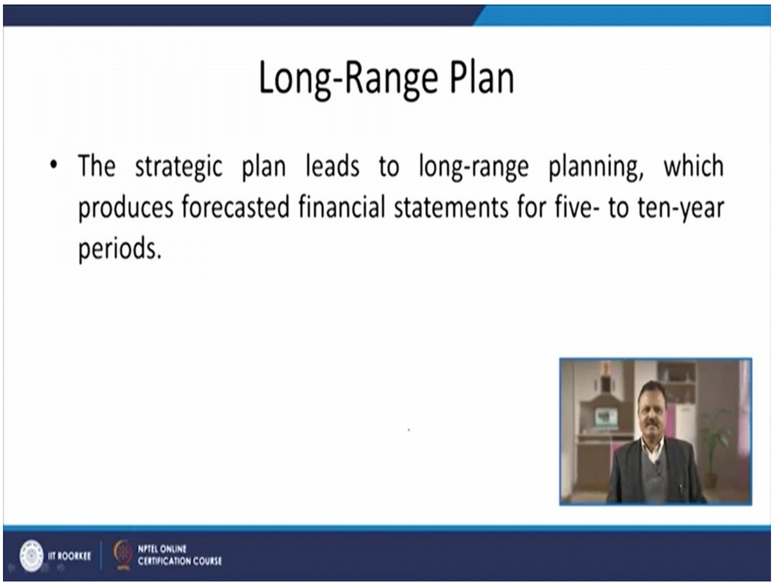

Similarly, we talk about the long range plan. So everything is almost same like the strategic plan. But the time horizon here is normally between five to ten years. Be there is because you cannot reach am say achieve the targets which you want to achieve 30 years form the line means down the line, You have to then start means say start sub-planning process.

So, strategic plan has to be then broken into the long term plans and the long term plans is you will plan for five years than may be for ten years, seven or may be eight years then for the next ten years, for the next ten years so that in next thirty years we want to reach there where we want to go up.

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Then is the capital budgets: Long-range plans are coordinated with capital budgets, which detail the planned expenditures for facilities, equipment, new products and other long-term investments. I told you earlier that capital budget means planning for acquiring the fixed facilities or the fixed assets, long term assets which can help us to achieve our long-range plans or the strategic plans. So because we have the limited resource funds, finance is always limited with every business, business organization, how that has to be distributed across the whole say set of fixed assets? How much land we have to acquire? How much building we have to construct? How much say plant machinery and other things we have too? Or whether construct the building we want to acquire the land or we will hire a building so now land is acquire only we will be hiring a building. We will put some machine and other equipment and start the manufacturing process. Later on when we means come up to a level in that case we will move up to our own buildings or our own land our own factory but initially we do not want to have because the investment is limited, so we want to avoid that investment in the land and the say building. So directly we can hire a building and then we can install the machinery there and start manufacturing and the operational process there, right? So, it is a long range plan which is say the, the, the next level plan to achieve the strategic plan, we divide it into five to ten years different plans and they are called as the long range plans.

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Now we come to the master budget. Here it is clearly written master budget, what is master budget – Summarizes the planned activities of all subunits of an organization. What are the subunits now? They are different departments. We prepare a budget for every department, we prepare a budget for, every department and when you put together it becomes a comprehensive document, right? As a government of India prepares the budgets, the budget of a country as a whole is prepared for the different ministries. How much we are going to spend on education? How much we are going to spend on say the production of say fertilizers, for the coal, for the steel, for the say services sector what is investments requirements? And when you put them together it becomes a budget instrument or the budget document. Similarly, in the company also, at the corporate level also we plan for the different sub areas and these sub areas are likes say we prepare a sales budget. We prepare the production budgets, we prepare the distribution budgets and we prepare the financial budgets and when you put all these four budgets together it becomes the master budget. So, in the sales and the production budget they are the part of the operating budget. When you are selling in the market and when you are investing to produce those sales, you are incurring some expenses, operating expenses, so you put in the profit and loss account on the credit side you put all the sales, on the debit side you put all the expenses and when compare the difference between the two you end up with the net profit before tax, after calculating the tax component you arrived at the net profit after tax. So, this is the result of the operating budget which is based upon estimate, planning for the sales and the productions; including the distribution and then is the second budget is to achieve that level of sales, to go for given level of investment into the manufacturing facility for acquiring the raw material paying to the labor, paying to the other distribution expenses, administrative expenses we need funds. How much funds we require for say facilitating the operating budget. For that reason we have to go for preparing the financial budgets. So these are sub-budgets sales budget, production budget, distribution budget and finance budget again putting them together it becomes the master budget.

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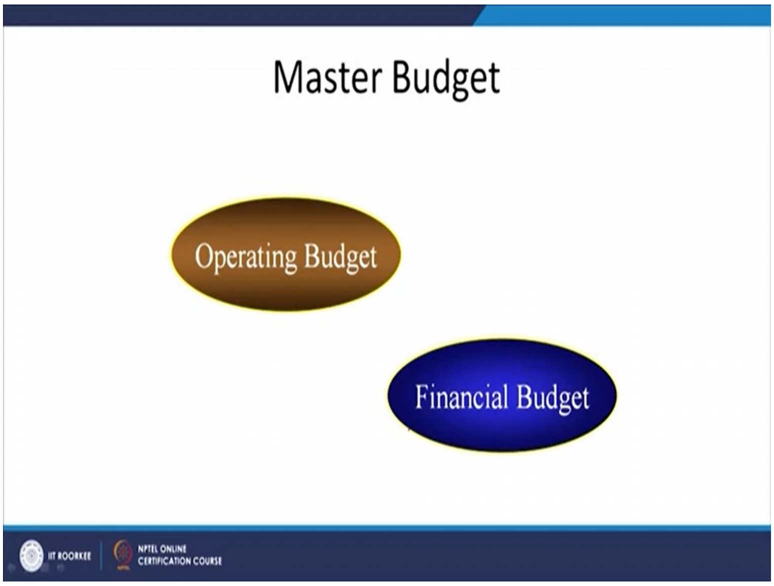

Now, again master budget I told you, operating budget and financial budget, it has two broad components Operating budgets includes sales budget, production budget distribution budget. Financial budget is the financial budget, so the components of the financial budgets are preparing two statements that is the cash flow statements and then the balance sheet right? And operating budget is we prepare the, we start with the sales budgets and to achieve that level of sales how much production is required and how to attain that given level of production.

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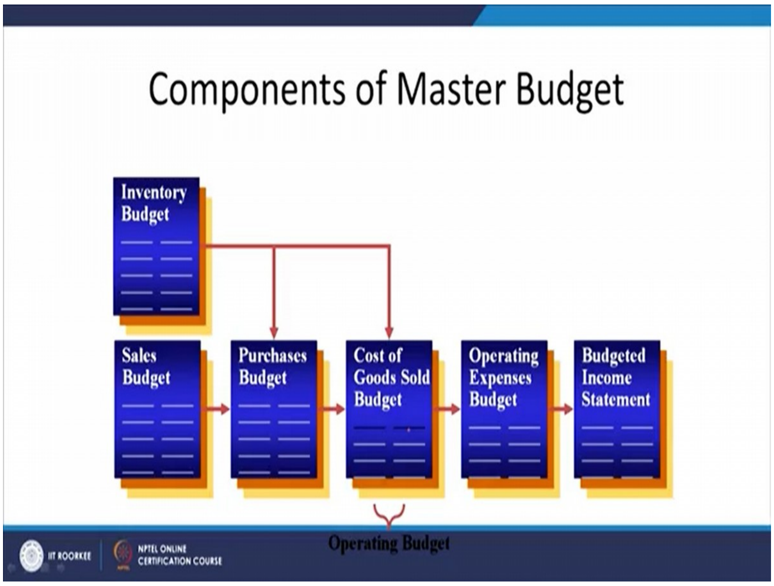

Now, let us talk about the components of the master budgets. Basically these are the components of the operating budgets. So, what are the sub-budget required to be prepared for the operating budget, what are the sub-budgets require to be prepared for the operating budget now you see these are some of the budgets given here inventory budget, sales budget, purchase budget, cost of goods-sold budget, operating expenses budgets and budgeted income statement. We are starting with the sales budget which is supported by the inventory budget, supported by the purchased budget, cost of good-sold budget, operating expenses budget and finally the net result is preparing the budgeted income statement, budgeted profit and loss account. Before you prepare the real profit and loss account at the end of the time horizon these days we do not only prepare monthly financial statements sorry annual financial statements. We prepare the quarterly financial statements also we know after every three months that what is our profit and loss situation what is our financial position means the financial position of the firm, are we moving in the right direction so that at the end of the year when we have four quarters information we would like to establish that we have been able to achieve the objectives for this year one, year which we stared with and we want to achieve those objectives. So, in the master budget particularly in the operating budget, we start with the sales budget, we start with the sales budget. Sales for-casting, we have to for-cast the sales depending upon many factors. Previous months, previous quarter sales, the market situation, existence of the various competitors in the market, availability of the different inputs like raw material and other expenses we have to prepare a comprehensive document and on the basis of the forecasted sales. If you have the for-casted sales information in your mind you know that now I have to produce this much. So, we will go for the first preparing of the sales budgets that how much we have to sale over the period of three months, next three months and then we will go for the backtracking. Now in the backtracking once the sales budgets is in a place, then the backtracking required now you prepare the production budget. So, in case of production budget we will see the inventory budget. Inventory budget means the raw material. How much raw material we already have in the go-down and how much is required to be purchases. So, total inventory requirement, total say raw material requirement, we will have to prepare the inventory budget. It is possible that whatever the material purchased in the past, we do not consume that fully, some part of the material is left and that is used in the next quarter or maybe in the next 6 months or in the next year. So, first we will see that how much is the inventory available with us, it may be possible that you want to sell in this coming quarter three thousand units of the product. For those three thousand units of the product we have already adjusting inventory with us, 500 units are there already with us in the warehouse and some raw material is also available with us in the go-down, so it means you have to now arrange for the raw material as well as the production for the remaining 2500 units. So inventory knowing inventory the status of inventory, how much inventory is already there, how much inventory we want to keep even at the end of that quartering question.

Finally, we will have to decide that what is the requirement for the current period? If it is available with us no need to purchase this but if we want to go for purchases then we come up to the purchase budget, how much purchases are required and when the purchases will be made. You have to think that the purchases are required as and when there is a need for different inputs in terms of material, in terms of other auxiliary expenses, water, lubricants say the electricity. All these things are required or may be means the operating expenses I mean including everything that is the power expenses, the water expenses or other expenses but in the purchase budget we talk about only purchases of raw material and then next step we go up to that is the calculating the cost of goods sold, but the cost of goods sold will be possible to be calculated once after inventory and purchase budget, we prepare the operating expenses budget. Means it not inventory which is required for production, you need other operating expenses also. How much labor will be required? How much other say factory overheads will be required, how much oiling, greasing and other kind of the inputs are required, those are called as the operating expenses. Out this total, how much will be the fix expenses like salaries like general expenses, other administrative expenses? How much are the fix operating expenses? How much are the variable operating expenses and how to arrange funds for those expenses? We will have to prepare the operating expenses budget. So once you have the budget for the purchase, raw material and the operating expenses, you put together all these things and finally means you know that how much we are going to sell? How much we are going to say invest for those sales? And when you put all these things in a profit and loss account right? When you put all these in a profit and loss account, this gives you statement which is called as the say your budgeted profit and loss account.

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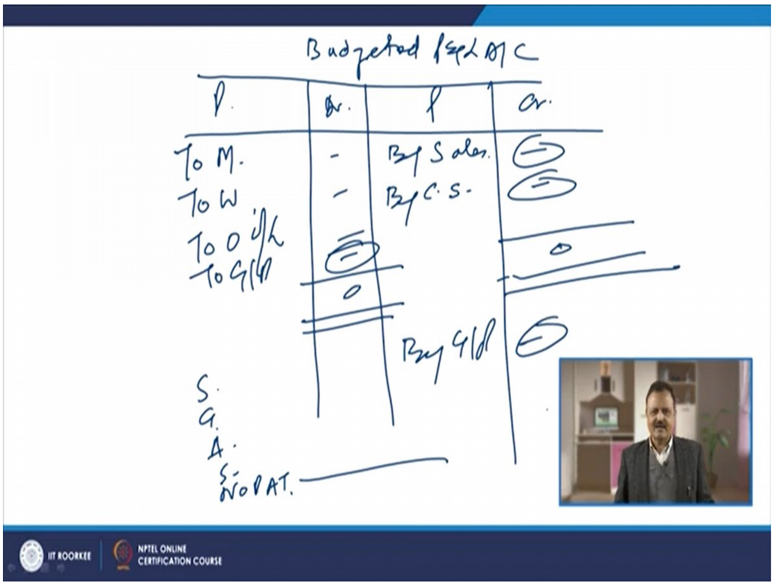

Now, for example, we are preparing a you can say you can call it a operating budget. So in the operating budget I am telling you they start with the budget, here it is the say a profit and loss account you can say it is the budgeted profit and loss account. So, what will you do here, this is the debit side, this is the credit side, this the particulars, this is the particulars so we will stay out here by sales, how much we are going to sale? We are planning to sale in the market this amount will come here, then you write here buy closing stock, right? How much closing stock of the finish goods as well as the inventory you want to keep? Means the raw material you want to keep to put it here. It means this is a total requirement if you see here, whatever the amount comes here that will be our total requirement, that we want to sell this much of the means we want to have this much of the production in this period.

Now, in this side for having this much of the production which will be sold in the market and partly retained as closing stock, you will have all the expenses here, which you call it as to material expenses, to labor expenses, to other overheads expenses, other overhead expenses, so these expenses will be putting here and when you try to balance these both the sides, you say that to gross profit, my gross profit is going to be this much, and then you pull the statement down.

So, here you take that by gross profit, GP comes here and then you go for the other indirect expenses like salaries, general expenses like then the administrative expenses, stationary all that, so once you adjust all this expenses, finally you calculate the net operating profit after tax when you adjust for the tax also. So, it means for the whole case means once you are preparing the sales budget, you are preparing the inventory budget, you are preparing the operating expenses budget.

So, finally it is very easy to prepare the budgeted profit and loss account and that is the ultimate purpose of the operating budget. We will practically prepare this budgets ourselves, we will prepare the sales budget, we will prepare the inventory budget, purchase budget, purchase disbursement budget all the budgets we will prepare and then we will prepare the sales budget also and finally we will learn how to prepare profit and loss budgeted account means over a period of time in the next lecture in in the coming classed, for this I stop here and remaining this with regard to budget and budgetary control I will discuss in the next class. Thank you very much.