

CHAPTER 5: BUDGETING

Preparation of Budgets: The process of preparing and using budgets will differ from organisation to organisation. However, there are a number of key requirements in the design of a budgetary planning and control process.

Co-ordination: Budgets provide a **means of co-ordination** of the business as a whole. In the process of establishing budgets, the various factors like production capacity, sales possibilities, and procurement of material, labour, etc. are balanced and co-ordinates so that all the activities proceed according to the objective.

Participative budgeting: CIMA defines participative budgeting as: A budgeting system in which all budget committee members are given the opportunity to apply their own budgets in practice.

Budget Manual: A budget manual is a collection of documents that contains key information for those involved in the planning process.

Identification of the principal budget factor: The principal budget factor is the factor that limits the activities of functional budgets of the organization. The early identification of this factor is important in the budgetary planning process because it indicates which budget should be prepared first.

There are 4 different types of capacities which are to be kept in view while preparing budgets:

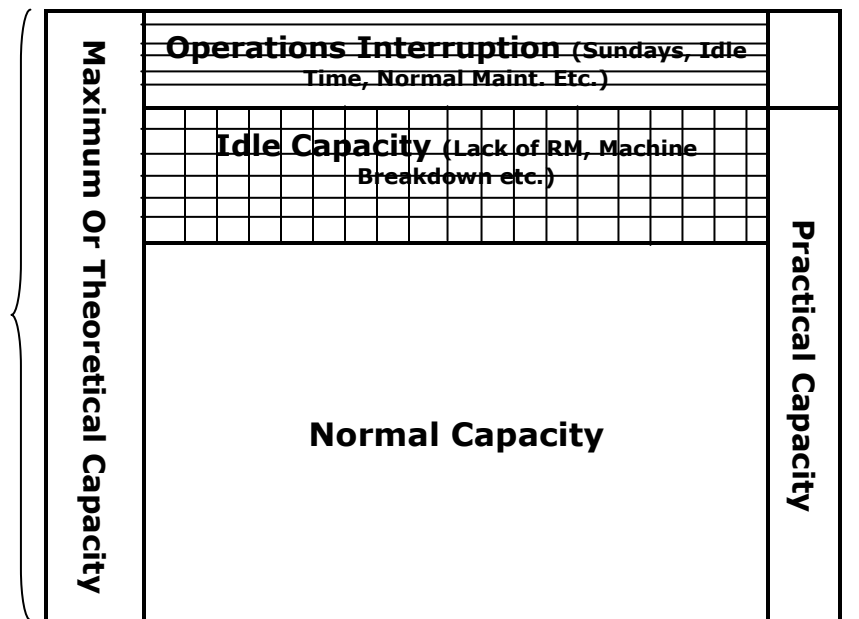
Maximum capacity = Max. no. of days in a period / No. of workers /
No. of hrs. etc.

Practical capacity = Maximum capacity – Sunday & statutory holidays &
normal maintenance & idle time.

Normal capacity = It is the average of the last 3-years normal
performance if there is any abnormal data, it is not to
be considered in computing the average.

Actual capacity = It can be determined only at the end of the period.
So it has no importance for preparation of budget.

The capacities can be illustrated as below:



Budget Variance: It is computed on the basis of fixed budgeting system where budget variance = budgeted cost – actual cost here. **The items are classified first in respective responsibility category & then the differences are computed individually & totally.**

Zero Based Budgeting (ZBB): Zero based budgeting is a decision oriented approach. In Zero Based budgeting no reference is made to previous level of expenditure. Zero based budgeting is completely indifferent to whether total budget is increasing or decreasing. CIMA has defined it “as a method of budgeting whereby all activities are revaluated each time a budget is set.”

ZBB is an expenditure control device where each division head has to justify the requirement of funds for each head of expenditure and prepare the budget accordingly, without reference to the past budget or achievement.

It is a planning and budgeting process, which requires each manager to justify his entire requests in detail from “scratch” .(hence zero-base)

Characteristics of ZBB: The Features of ZBB are:

1. Manager of a decision unit has to completely justify why there should be at all any budget allotment for his decision unit. This justification is to be made a fresh without making reference to previous level of spending in his department.
2. Activities are identified in decision packages.
3. Decision packages are ranked in order of priority.
4. Packages are evaluated by systematic analysis.
5. Under this approach there exists a frank relationship between superior and subordinates. Management agrees to fund for a specified service and manager of the decision unit clearly accepts to deliver the service.
6. Decision packages are linked with corporate objectives, which are clearly laid down.
7. Available resources are directed towards alternatives in order of priority to ensure optimum results.

Traditional Budget Vs. ZBB:

Sl. #	Traditional Budget	Zero Based Budget
1	Accounting Oriented	Responsibility Oriented
2	Past Budgets are used as reference. At times it will be just inflation of past budgets	Fresh approach without any previous reference. Nothing is taken into account without justification.
3	Routine Approach	Investigative approach
4	Not clear and responsive	Clear and Responsive
5	Top management decides why particular amount is to be spent.	User department justifies why the amount is to be spent and accordingly approved by the management

Question

Describe the process of zero-base budgeting.

Answer

The zero Base Budgeting involves the following steps:

- a. Determine a set of objectives.

- b. Decide about the extent to which the technique of ZBB is to be applied, Whether in all areas of firm's activities or only in a few selected areas on trial basis.
- c. Identify those areas where decisions are required to be taken.
- d. Develop decision packages and rank them in order of preferences.
- e. Prepare the budget, i.e. translating decision packages into practicable units/items and allocating financial resources

Question

What are the advantages and limitations of Zero base Budgeting?

Answer

Advantages of ZBB are:

- a. Provides a **systematic approach for the evaluation** of different activities.
- b. **Ensures various activities** performed by the organisation are **critical** for achieving its objectives.
- c. Provides an opportunity to the management to allocate resources for various activities only after having a thorough **cost-benefit analysis**.
- d. **Maximum efficiency:** Wasteful expenditure is identified and eliminated.
- e. **Goal Congruence:** Departmental budgets are closely linked with corporation objectives.
- f. Facilitates introducing the system of **Management by Objectives**.

Limitations of ZBB are:

- a. **Lack of coordination:** Various operational problems are likely to be faced in implementing. It requires the wholehearted support from Top Management.
- b. It is **time consuming** as well as **costly**.
- c. It requires proper **trained managerial** staff.
- d. Various operational problems in implementing.

Question

In each of the following independent situations, state with a brief reason whether 'Zero Base Budgeting' (ZBB) or 'Traditional Budgeting' (TB) would be more appropriate for year II.

- a. *A company producing a certain product has done extensive ZBB exercise in year I. The activity level is expected to marginally increase in year II.*
- b. *The sales manager of a company selling three products has the intuitive feeling that in year II, sales will increase for one product and decrease for the other two. His expectation cannot be substantiated with figures.*
- c. *The top management would like to delegate responsibility to the functional managers for their results during year II.*
- d. *Resources are heavily constrained and allocation for budget requirements is very strict.*

Answer

- a. The company has done extensive exercise in year-I that can be used as a basis for budgeting in year-II by incorporating increase in costs / revenue at expected activity level. Hence, **Traditional Budgeting** would be more appropriate for the company in year-II.
- b. In Traditional Budgeting system budgets are prepared on the basis of previous year's budget figures with expected change in activity level and corresponding adjustment in the cost and prices. But under Zero Base Budgeting (ZBB) the estimations or projections are converted into figures. Since, sales manager is unable to substantiate his expectations into figures so **Traditional Budgeting** would be preferred against Zero Base Budgeting.
- c. **Zero Base Budgeting** would be appropriate as ZBB allows top-level strategic goals to be implemented into the budgeting process by tying them to specific functional areas of the organization, where costs can be first grouped, then measured against previous results and current expectations.
- d. Zero Base Budgeting allocates resources based on order of priority up to the spending cut-off level (maximum level upto which spending can be made). In an organisation where resources are constrained and budget is allocated on requirement basis, **Zero Base Budgeting** is more appropriate method of budgeting.

Question

What do you mean by a flexible budget? Give an example of an industry where this type of budget is typically needed?

Answer

A flexible budget is a budget which, by recognizing the difference between fixed, semi-variable and variable costs, is designed to change in relation to the level of activity attained. i.e. the budget is prepared for different levels of activity. These sort of budgets are used in the following types of industries.

- a. seasonal products – e.g. soft drink industry
- b. industries influenced by change in fashion.
- c. Industries which keep on introducing new products / new designs.

Question

What are the various formulae used in calculating budget ratios?

Answer

The various formulae that are used for calculating budget ratios are:

- a. Efficiency Ratio $= (\text{Standard hours} \div \text{Actual hours}) \times 100$
- b. Activity Ratio $= (\text{Standard hours} \div \text{Budgeted hours}) \times 100$
- c. Calendar Ratio $= (\text{Available working days} \div \text{budgeted working days}) \times 100$
- d. Standard Capacity Usage Ratio $= (\text{Budgeted hours} \div \text{Max. possible hours in the budgeted period}) \times 100$
- e. Actual Capacity Usage Ratio $= (\text{Actual hours worked} \div \text{Maximum possible working hours in a period}) \times 100$
- f. Actual Usage of Budgeted Capacity Ratio $= (\text{Actual working hours} \div \text{Budgeted hours}) \times 100$

Performance Budgeting (PB): It is the process of analysing, identifying, simplifying and crystallising specific performance objectives, of a job to be achieved over a period, within the framework of firm's overall objectives, and within the framework of the purpose and objectives of the job.

Performance Budgeting **lays immediate stress on the achievement of specific goals over a period of time.** It aims at a continuous growth of the firm so that it continues to meet the dynamic needs of its growing clientele and customers. It requires preparation of periodic performance reports, which compare budget and actual performance to find out existing variances.

Traditional budgeting vs. Performance budgeting

1. The traditional budgeting (TB) gives more emphasis on the financial aspect than the physical aspects or performance. **PB aims at establishing a relationship between the inputs and the outputs.**
2. Traditional budgets are generally prepared with the main basis towards the objects or items of expenditure i.e. it highlights the items of expenditure, namely, salaries, stores and materials, rates rents and taxes and so on. In the PB the **emphasis is more on the functions** of the organisation, the programmes to discharge these function and the activities which will be involved in undertaking these programmes.

Benchmarking

Benchmarking is the process of comparing one's business processes and performance metrics to industry bests or best practices from other industries. Dimensions typically measured are quality, time and cost. In the process of best practice benchmarking, management identifies the best firms in their industry, or in another industry where similar processes exist, and compares the results and processes of those studied (the "targets") to one's own results and processes. In this way, they learn how well the targets perform and, more importantly, the business processes that explain why these firms are successful.

Benchmarking is used to measure performance using a specific indicator (cost per unit of measure, productivity per unit of measure, cycle time of x per unit of measure or defects per unit of measure) resulting in a metric of performance that is then compared to others. Benchmarking exercise is based on **best practices** rather than **best performances**.

Benchmarking is also referred to as "best practice benchmarking" or "process benchmarking"; this process is used in management and particularly strategic management, in which organizations evaluate various aspects of their processes in relation to best practice companies' processes, usually within a peer group defined for the purposes of comparison. This then allows organizations to develop plans on how to make improvements or adapt specific best practices, usually with the aim of increasing some aspect of performance. Benchmarking may be a one-off event, but is often treated as a continuous process in which organizations continually seek to improve their practices.

Question

What are benchmarking code of conduct?

Answer

Benchmarking is the process of identifying and learning from the best practices, anywhere in the world. It is a powerful tool for continuous improvement.

To contribute to efficient, effective and ethical benchmarking, individuals agree for themselves and their organisation to be abided by the following principles for the benchmarking with other organisations.

- a. Principle of legality: If there is likely to be any legal problem, then such thing should not be done.
- b. Principle of exchange: Similar type of information and at similar level is to be exchanged.
- c. Principle of confidentiality: Information should not be passed to other organisations.
- d. Principle of use: Information must be used only for Benchmarking purposes and not for other purposes.
- e. Principle of first party contact: The person who is to be contacted for exchange of information is to be specified by each organisation.
- f. Principle of third party contact: Prior consent of the party is to be obtained before passing information to another organisation or person.
- g. Principle of preparation: Make the most of your Benchmarking partners time by being fully prepared for exchange of information.
- h. Principle of completion: Complete Benchmarking study to the satisfaction all Benchmarking partners by fulfilling all mutually agreed commitments.
- i. Principle of understanding: understand how your Benchmarking would like to be treated.

Question

Explain briefly stages involved in the process of Benchmarking.

Answer

The process of benchmarking requires a Company to identify the areas i.e. processes, activity etc. which are central to its business and then selects the top - performing companies in those areas.

1. Planning:

- a. Determination of benchmarking goal statement: This requires identification of areas to be benchmarked. In practice, one should start with the identification of those areas which have to be really good to be really successful.
- b. Identification of best performance: Once the benchmarked goal statement are defined, the step is seeking the best of the breed of best of the best.
- c. Establishment of the benchmarking or process improvement team: Ideally this should include the persons who are most knowledgeable about the internal operations and will be directly affected by changes due to benchmarking.
- d. Defining the relevant benchmarking measurement: Relevant measures will not include the measures used by the organisation today but they will be refined measures that comprehend the true performance differences.

2. **Collection of data and information:** The data gathering for benchmarking could be done through national/international clearing houses, mail surveys, suppliers, company visits, telephone, interviews etc. In recent years national and international clearing houses have been set up.

3. **Analysing the findings:** The analysing of findings of step (2) requires following:
- a. Review the findings and produce tables, charts and graphs to support the analysts.
 - b. Identify gaps in performance between our organisation and better performers.
 - c. Seek explanations for the gaps in performance. The performance gaps can be positive, negative or zero.
 - d. Ensure that comparisons are meaningful and credible.
 - e. Communicate the findings to those who are affected.
 - f. Identify realistic opportunities for improvements.

4. **Recommendations:** This involves making recommendations requiring:
 - a. Deciding the feasibility of making the improvements in the light of the conditions that apply within own organisation.
 - b. Agreement of the improvements that are likely to be feasible.
 - c. Producing a report on the Benchmarking in which the recommendations are included.
 - d. Obtaining the support of key stakeholder groups for making the changes needed.
 - e. Developing action plan(s) for implementation.
5. **Monitoring and reviewing:** This involves:
 - a. Evaluating the benchmarking process undertaken and the results of the improvements against objectives and success criteria plus overall efficiency and effectiveness.
 - b. Documenting the lessons learnt and make them available to others.
 - c. Periodically re-considering the benchmarks

Question

Describe the four types of benchmarking of critical success factors.

Answer

Benchmarking is primarily classified into **internal** (comparing performance between different groups or teams within an organization) or **external** (comparing performance with companies in a specific industry or across industries). This is further classified into:

Within the above broad categories, the Benchmarking is of following types:

- a. **Product benchmarking** (Reverse Engineering. This is called so because basing on the best available product (bench mark product); alternative one is developed with similar features.) - The process of designing new products or upgrades to current ones based on bench marked product.
- b. **Process benchmarking:** It involves the comparison of an organisation critical business processes and operations against best practice organization that performs similar work or deliver similar services.
- c. **Competitive benchmarking:** It involves the comparison of competitors products, processes and business results with own.

- d. **Strategic benchmarking:** It is similar to the process benchmarking in nature but differs in its scope and depth. This involves observing how others compete. This type is usually not industry specific, meaning it is best to look at other industries.
- e. **Global benchmarking:** It is a benchmarking through which distinction in international culture, business processes and trade practices across companies are bridged and their ramification for business process improvement are understood and utilized.
- f. **Functional Benchmarking** or Generic Benchmarking: This type of benchmarking is used when organisations look to benchmark with partners drawn from different business sectors or areas of activity to find ways of improving similar functions or work processes.
- g. **Internal Benchmarking:** It involves seeking partners from within the same organization, for example, from business units located in different areas.
- h. **External Benchmarking:** It involves seeking help of outside organisations that are known to be best in class. External benchmarking provides opportunities of learning from those who are at the leading edge, although it must be remembered that not every best practice solution can be transferred to others.
- i. **Financial benchmarking** - performing a financial analysis and comparing the results in an effort to assess your overall competitiveness and productivity. E.g. Comparing ROIs', Capital invested etc.
- j. **Performance benchmarking** - allows the initiator firm to assess their competitive position by comparing products and services with those of target firms.
- k. **Energy benchmarking** - process of collecting, analysing and relating energy performance data of comparable activities with the purpose of evaluating and comparing performance between or within entities.^[7] Entities can include processes, buildings or companies. Benchmarking may be internal between entities within a single organization, or - subject to confidentiality restrictions - external between competing entities.

Question

Explain the difficulties in Benchmarking.

Answer

The difficulties in implementing Benchmarking are:

- a. **Time consuming:** Benchmarking is time consuming and at times difficult. It has significant requirement of staff time and Company

resources. Companies may waste time in benchmarking non-critical functions.

- b. **Lack of management Support:** Benchmarking implementation requires the direct involvement of all managers. The drive to be best in the industry or world cannot be delegated.
- c. **Resistance from employees:** It is likely that there may be resistance from employees.
- d. **Paper Goals:** Companies can become pre-occupied with the measures. The goal becomes not to improve process, but to match the best practices at any cost.
- e. **Copy-paste attitude:** The key element in benchmarking is the adaptation of a best practice to tailor it to a company's need and culture. Without that step, a company merely adopts another Company's process. This approach condemns benchmarking to fail leading to a failure of benchmarking goals.

Costs

The three main types of costs in benchmarking are:

- **Visit Costs** - This includes hotel rooms, travel costs, meals, a token gift, and lost labour time.
- **Time Costs** - Members of the benchmarking team will be investing time in researching problems, finding exceptional companies to study, visits, and implementation. This will take them away from their regular tasks for part of each day so additional staff might be required.
- **Benchmarking Database Costs** - Organizations that institutionalize benchmarking into their daily procedures find it is useful to create and maintain a database of best practices and the companies associated with each best practice now.

The cost of benchmarking can substantially be reduced through utilizing the many internet resources that have sprung up over the last few years. These aim to capture benchmarks and best practices from organizations, business sectors and countries to make the benchmarking process much quicker and cheaper.