BUDGET AND BUDGETARY CONTROL

Q.NO.1:- What do you mean by Budgets? State its features.

Ans:-

Meaning

'A financial and/or quantitative statement prepared prior to a defined period of time, of the policy to be pursued during that period for the purpose of achieving a given objective.

Features

1.Estimation : A budget is a statement that is always prepared prior to a defined period of time. This means that budget is always prepared for future period and not for the past. The point is that the time frame for which it is prepared is certain. It cannot be prepared for indefinite period of time.

2. Quantitative and Value: Budget is prepared either in quantitative details or monetary details or both. This means that budget will show the planning in terms of rupees or in quantity or both.

Policy formulation : Every organization has well defined objectives, which are to be achieved in a particular span of time. It is of --paramount importance that there should be systematic efforts to bring them into reality. As a part of these efforts, it is necessary to formulate a policy and it is reflected in the budget.

Q.NO.2:- What do you mean by Budgetary Control ? Explain its stages.

Ans:-

Meaning

It is actually a means of control in which the actual results are compared with the budgeted results so that appropriate action may be taken with regard to any deviations between the two.

Stages

i. **Developing Budgets: The first stage in budgetary control is developing various budgets. It will be necessary to identify the budget centers in the organization and budgets will have to develop for each one of them. Thus budgets are developed for functions like purchase, sale, production, manpower planning as well as for cash, capital expenditure, machine hours, labor hours and so on. Utmost care should be taken while developing the budgets.**

ii. **Recording Actual Performance: There should be a proper system of recording the actual performance achieved. This will facilitate the comparison between the budget and the actual. An efficient accounting and cost accounting system will help to record the actual performance effectively.**

iii. **Comparison of Budgeted and Actual Performance: One of the most important aspects of budgetary control is the comparison between the budgeted and the actual performance. The objective of such comparison is to find out the deviation between the two and provide the base for taking corrective action.**

iv. **Corrective Action: Taking appropriate corrective action on the basis of the comparison between the budgeted and actual results is the essence of budgeting. A budget is always prepared for future and hence there may be a variation between the budgeted results and actual results. There is a need for investigation of the same and take appropriate action so that the deviations will not repeat in the future. Responsibilities can be fixed on proper persons so that they can be held responsible for any such deviations.**

Q.NO.3:- What are the objects of Budgeting?

Ans:-

Objects

i. **Planning: Planning is necessary for doing any work in a systematic manner. A well- prepared plan helps the organization to use the scarce resources in an efficient manner and thus achieving the predetermined targets becomes easy. A budget is always prepared for future period and it lays down targets regarding various aspects like purchase, production, sales, manpower planning etc. This automatically facilitates planning.**

ii. **Co-ordination: For achieving the predetermined objectives, apart from planning, coordinated efforts are required. Budgeting facilitates coordination in the sense that budgets cannot be developed in isolation. For example, while developing the production budget, the production manager will have to consult the sales manager for sales forecast and purchase manager for the availability of the raw material. Production budget cannot be developed in isolation. Similarly the purchase and sales budget as well as** other functional budgets like cash, capital expenditure, manpower planning etc cannot be developed without considering other functions. Hence the coordination is automatically facilitated.

iii. **Control:** Planning is looking ahead while controlling is looking back. Preparation of budgets involves detailed planning about various activities like purchase, sales, production, and other functions like marketing, sales promotion, manpower planning. But planning alone is not sufficient. There should be a proper system of controlling which will ensure that the work is progressing as per the plan. Budgets provide the basis for such controlling in the sense that the actual performance can be compared with the budgeted performance. Any deviation between the two can be found out and analyzed to ascertain the reasons behind the deviation so that necessary corrective action can be taken to rectify the same. Thus budgeting helps immensely in controlling function.

Q.NO. 4:-What are the advantages/benefits of Budgetary control?

Ans:-

Advantages / Benefits

i. Budgeting facilitates planning of various activities and ensures that the working of the organization is systematic and smooth.

ii. Budgeting is a coordinated exercise and hence combines the ideas of different levels of management in preparation of the same. Any budget cannot be prepared in isolation and therefore coordination among various departments is facilitated automatically.

iii. Budgeting helps planning and controlling income and expenditure so as to achieve higher profitability and also act as a guide for various management decisions.

iv. Budgeting is an effective means for planning and thus ensures sufficient availability of working capital and other resources.

v. It is extremely necessary to evaluate the actual performance with predetermined parameters. Budgeting ensures that there are well-defined parameters and thus the performance is evaluated against these parameters.

vi. As the resources are directed to the most productive use, budgeting helps in reducing the wastages and losses.

Q.NO.5:-What are the disadvantages/limitations of Budgetary control?

Ans:-

i. **Estimates:-** Budget may or may not be true, as they are based on estimates. The assumptions about future evenets may or may not actually happen.

ii. **Rigidity:-** Budgets are considered as rigid document. Too much emphasis on budgets may affect day to day operations and ignores the dynamic state of organisational functioning.

iii. **False sense of security:-** Mere budgeting cannot lead to profitability . Budgets cannot be executed automatically. It may create a false sense of security that everything has been taken care of in the budgets.

iv. **Lack of co-ordination:-** Staff co-operation is usually not available during Budgetary control exercise.

v. **Time and cost:-** The introduction and implementation of the system may be expensive.

Q.NO.6:- Discuss the Process of Budgetary Control.

Ans:-

i. **Budget Committee: (Important for short note):** In small or medium size organizations, the budget related work may be carried out by the Chief Accountant himself. Due to the size of the organization, there may not be too many problems in implementation of the budgetary control system. However, in large size organization, there is a need of a budget committee consisting of the chief executive, budget officer and heads of main departments in the organization.

The main **Functions** of the budget committee are (important)

a. to get the budgets prepared ,
b. to scrutinize the same,
c. to lay down broad policies regarding the preparation of budgets,
d. to approve the budgets, to suggest for revision,
e. to monitor the implementation and to recommend the action to be taken in a given situation.

ii. **Budget Centers: (Important)** Establishment of budget centers is another important pre-requisite of a sound budgetary control system. A budget center is a group of activities or a section of the organization for which budget can be developed. For example, manpower planning budget, research and development cost budget, production and production cost budget, labor hour budget and so on. Budget centers should be defined clearly so that preparation becomes easy.

iii. **Budget Period:** A budget is always prepared prior to a defined period of time. This means that the period for which a budget is prepared is decided in advance. Thus a budget may be prepared for three years, one year, six months, one month or even for one week. Generally it can be said that the functional budgets like sales, purchase, production etc. are prepared for one year and then broken down on monthly basis. Budgets like capital expenditure are generally prepared for a period from 1 year to 3 years

iv. **Preparation of an Organization Chart:** There should be an organization chart that shows clearly defined authorities and responsibilities of various executives. The organization chart will define clearly the functions to be performed by each executive relating to the budget preparation and his relationship with other executives.

v. **Budget Manual(Important for short note):** A budget manual is defined by ICMA as ' a document which sets out the responsibilities of the person engaged in, the routine of and the forms and records required for budgetary control'.

The budget manual thus is a schedule, document or booklet, which contains different forms to be used, procedures to be followed, budgeting organization details, and set of instructions to be followed in the budgeting system. It also lists out details of the responsibilities of different persons and the managers involved in the process.

Contents of Budget manual

i. Objectives and managerial policies of the business concern.
ii. Internal lines of authorities and responsibilities.
iii. Functions of the budget committee including the role of budget officer.
iv. Budget period
v. Detailed program of budget preparation
vi. Accounting codes and numbering
vii. Follow up procedures.

vi. **Principal Budget Factor or Key Factor:** A key factor or a principal budget factor [also called as constraint] is that factor the extent of whose influence must first be assessed in order to prepare the functional budgets. Normally sales is the key factor or principal budget factor but other factors like production, purchase, skilled labor may also be the key factors. For example, a company has production capacity to produce 30,000 tones per annum but if the sales forecast tells that the market can absorb only 20,000 units, there is no point in producing 30,000 units. Thus the sale is the key factor in this case. On the other hand, if the company has capacity to produce 30,000 units and the market has the capacity to absorb the entire production which means that sales is not the key factor but if raw material is available in limited quantity so that only 25,000 units can be produced, the raw material will become the key factor. The key factor puts restrictions on the other functions and hence it must be considered carefully in advance.

A typical list of some of the key factors is given below.

- ✓ Sales: Consumer demand, shortage of sales staff, inadequate advertising
- ✓ Material: Availability of supply, restrictions on import
- ✓ Labor: Shortage of labor
- ✓ Plant: Availability of capacity, bottlenecks in key processes
- ✓ Management: Lack of capital, pricing policy, shortage of efficient executives, lack of know- how, faulty design of the product etc.

vii. **Establishment of Adequate Accounting Records:** It is essential that the accounting system should be able to record and analyze the transactions involved. A chart of accounts or accounts code should be maintained which may correspond with the budget centers for establishment of budgets and finally control through budgets.

Q.NO.6:- Discuss the various types of Budgets according to area of Operation.

Ans:-

Functional Budgets: The functional budgets are prepared for each function of the organization. These budgets are normally prepared for a period of one year and then broken down to each month. The following budgets are included in this category.

i. **Sales Budget:** A Sales Budget shows forecast of expected sales in the future period [the period is well

defined] and expressed in quantity of the product to be sold as well as the monetary value of the same. A Sales Budget may be prepared product wise, territories/area/country wise, customer group wise, salesmen wise as well as time wise like quarter wise, month wise, weekly etc.

Factors to be considered while preparing sales budget

a) **Analysis of past sales:** **Analysis of sales for the last 5-10 years will provide valuable information like the long term trend, seasonal trends, cyclical fluctuations and other relevant information like customer preference analysis, shift in demand, competition and other environmental factors. This information can be used to predict the likely future demand of the product.**

b) **Estimates given by the sales staff:** **Sales staff of the business organization works in the field and hence they know the market situation very well. They have very close interaction with the market and are in a better position to know the demand pattern and other such trends. However, care is to be taken that the subjective element in the sales estimates given by the sales staff should be eliminated to arrive at a realistic sales forecast.**

c) **Market Potential Analysis:** **Marketing Research helps any business organization to collect the data regarding markets, demand pattern, customer preferences, market potential and other factors like economic factors and environmental factors. From this analysis, market potential can be worked out which will be used in the sales budget.**

d) **Dependent Factor:** **Demand of a product is dependent upon certain factors. For example, the demand for petrol and diesel is dependent on the number of vehicles plying though the roads. Analysis of such dependent factor will help to prepare the sales forecast which can be used in the sales budget. A business firm can use any of the above methods or a combination of the above methods to prepare sales forecast and incorporate the same in the sales budget.**

ii. **Production Budget:** **This budget shows the production target to be achieved in the next year or the future period. The production budget is prepared in quantity as well as in monetary terms. Before preparation of this budget it is necessary to study the principal budget factor or the key factor. The principal budget factor can be sales demand or the production capacity or availability of raw material. The policy of the management regarding the inventory is also taken into consideration. The production budget is normally prepared for a period of one year and then broken down on monthly basis. Production targets are decided by adding the budgeted closing inventory in the sales forecast and subtracting the opening inventory from the total of the same. Production Cost Budget is prepared by multiplying the production targets by the budgeted production cost per unit.**

iii. **Material Purchase Budget:** **This budget shows the quantity of materials to be purchased during the coming year. For the preparation of this budget, production budget is the starting point if it is the key factor. If the raw material availability is the key factor, it becomes the starting point. The desired closing inventory of the raw materials is added to the requirement as per the production budget and the opening inventory is subtracted from the gross requirements. This budget is prepared in quantity as well as in the monetary terms and helps immensely in planning of the purchases of raw materials.**

iv. **Cash Budget:** **A cash budget is an estimate of cash receipts and cash payments prepared for each month. In this budget all expected payments, revenue as well as capital and all receipts, revenue and capital are taken into consideration. The main purpose of cash budget is to predict the receipts and payments in cash so that the firm will be able to find out the cash balance at the end of the budget period. This will help the firm to know whether there will be surplus cash or deficit at the end of the budget period. It will help them to plan for either investing the surplus or raise necessary amount to finance the deficit.**

v. **Direct Labor Budget:** **The labor budget estimates the labor required for smooth and uninterrupted production. The labor budget shows the number of each type or grade of workers required in each period to achieve the budgeted output, budgeted cost of such labor, period wise and period of training necessary for different types of labor.**

vi. **Factory Overhead Budget:** **This budget is prepared for planning of the factory overheads to be incurred during the budget period. In this budget the overheads should be shown department wise so that responsibility can be fixed on proper persons. Classification of factory overheads into fixed and variable components should also be shown in this budget.**

vii. **Administrative Overhead Budget:** This budget covers the administrative costs for non-manufacturing business activities. The administrative overheads include expenses like office expenses, office salaries, directors' remuneration, legal expenses, audit fees, rent, interest, property taxes, postage, telephone, telegraph etc.

viii. **Capital Expenditure Budget:** Capital expenditure is incurred with a long - term perspective and with the objective of augmenting the earning capacity of the firm in the long run. Capital expenditure results in either acquisition of fixed asset or permanent improvement in the existing fixed assets. Another important feature of capital expenditure is that the amount involved is very heavy and the decision to incur capital expenditure is not reversible. Hence a careful planning is required before decision to incur capital expenditure is taken. In the budget of capital expenditure, apart from the planning of incurring the expenditure, evaluation of the same is also shown. This budget therefore becomes extremely crucial as it not only plans the expenditure but also evaluates the same and helps in arriving at a decision.

ix. **Manpower Planning Budget:** This budget shows the requirement of manpower in the budget period. The categories in which manpower is required are also shown in this budget. The requirement of manpower depends on the expansion plans of the organization and also on the expected separations during the budget period.

x. **Research and Development Cost Budget:** This budget is one of the important tools for planning and controlling research and development costs. It helps management in planning the research and development activities well in advance and also about the fairness of the expenditure. Research and development is one of the important activities of any firm and hence proper planning and coordination is required for effectiveness of the same. This budget also helps to plan the requirement of necessary staff for carrying out research and development.

xi. **Master Budget:** A Master Budget which is also called as 'Comprehensive Budget' is a consolidation of all the functional budgets. It shows the projected Profit and Loss Account and Balance Sheet of the business organization. For preparation of this budget, all functional budgets are combined together and the relevant figures are incorporated in preparation of the projected Profit and Loss Account and Balance Sheet. Thus Master Budget is prepared for the entire organization and not for individual functions.

Q.NO.7:- What do you mean by Fixed and Flexible budget?

Ans:-

Fixed Budgets:

- When a budget is prepared by assuming a fixed percentage of capacity utilization, it is called as a fixed budget.
- For example, a firm may decide to operate at 90% of its total capacity and prepare a budget showing the projected profit or loss at that capacity.
- For preparation of this budget, sales forecast will have to be prepared along with the cost estimates. Cost estimates can be prepared by segregating the costs according to their behavior i.e. fixed and variable. Cost predictions should be made element wise and the projected profit or loss can be worked out by deducting the costs from the sales revenue.

Flexible Budgets:

- A flexible budget is a budget that is prepared for different levels of capacity utilization.
- It can be called as a series of fixed budgets prepared for different levels of activity.
- For example, a budget can be prepared for capacity utilization levels of 50%, 60%, 70%, 80%, 90% and 100%.
- The basic principle of flexible budget is that if a budget is prepared for showing the results at say, 15,000 units and the actual production is only 12,000 units, the comparison between the expenditures, budgeted and actual will not be fair as the budget was prepared for 15,000 units. Therefore a flexible budget is developed for a relevant range of production from 12,000 units to 15,000 units. Thus even if the actual production is 12,000 units, the results will be comparable with the budgeted performance of 12,000 units. Thus a flexible budget covers a range of activity, it is flexible i.e. easy to change with variation in production levels and it facilitates performance measurement and evaluation.
- While preparing flexible budget, it is necessary to study the behavior of costs and divide them in fixed,

variable and semi variable. After doing this, the costs can be estimated for a given level of activity.

- It is also necessary to plan the range of activity. A firm may decide to develop flexible budget for activity level starting from 50% to 100% with an interval of 10% in between. It is necessary to estimate the costs and associate them with the chosen level of activity.
- Finally the profit or loss at different levels of activity will be computed by comparing the costs with the revenues.

Need for preparing flexible Budget

i. Seasonal fluctuations in sales and production,
ii. Introduction of new products, product designs and versions on a frequent basis,
iii. Industries engaged in make –to-order business like shipbuilding.
iv. An industry which is influenced by changes in fashion, and
v. General changes in sales.

Q.NO.8:- Discuss the various types of budgets according to Time.

Ans:-

According to Time , budgets are divided in the following categories.

i. **Short Term Budget:** Any budget that is prepared for a period up to one year is known as Short Term Budget. Functional budgets are normally prepared for a period of one year and then it is broken down month wise.
ii. **Medium Term Budget:** Budget prepared for a period 1-3 years is Medium Term Budget. Budgets like Capital Expenditure, Manpower Planning are prepared for medium term.
iii. **Long Term Budgets:** Any budget exceeding 3 years is known as Long Term Budgets. Master Budget is normally prepared for long term. In the modern days due to uncertainty, very few budgets are prepared for long term.

Q.NO.9:- What is Zero Base Budgeting? Explain the stages involved in Zero Base Budgeting.

Ans:-

Meaning:

- Zero Base Budgeting is method of budgeting whereby all activities are revaluated each time budget is formulated and every item of expenditure in the budget is fully justified. Thus the Zero Base Budgeting involves from scratch or zero.
- In incremental budgeting or traditional budgeting, previous year's figures are taken as base and based on the same the budgeted figures for the next year are worked out. Thus the previous year is taken as the base for preparation of the budget.
- In Zero Based Budgeting, the beginning is made from scratch or zero and each activity and function is reviewed thoroughly before sanctioning the same and all expenditures are analyzed and sanctioned only if they are justified.

Stages:-

i. Each separate activity of the organization is identified and is called as a decision package. Decision package is actually nothing but a document that identifies and describes an activity in such a manner that it can be evaluated by the management and rank against other activities competing for limited resources and decide whether to sanction the same or not.
ii. It should be ensured that each decision package is justified in the sense it should be ascertained whether the package is consistent with the goal of the organization or not.
iii. If the package is consistent with the overall objectives of the organization, the cost of minimum efforts required to sustain the decision should be determined.
iv. Alternatives for each decision package are considered in order to select better and cheaper options.
v. Based on the cost and benefit analysis a particular decision package/s should be selected and resources are allocated to the selected package.

Q.NO.10:- State the merits and demerits of zero Base Budgeting.

Ans:-

Merits

1.Detailed Cost benefit analysis from Scratch: ZBB facilitates review of various activities right from the scratch and a detailed cost benefit study is conducted for each activity. Thus an activity is continued only if the cost benefit study is favorable. This ensures that an activity will not be continued merely because it was conducted in the previous year.

2.**Efficient Allocation of Resources:** A detailed cost benefit analysis results in efficient allocation of resources and consequently wastages and obsolescence is eliminated..

3.**Improves communication and coordination:** ZBB facilitates improvement in communication and co-ordination amongst the staff.

4.**Awareness:** Awareness amongst the managers about the input costs is created which helps the organization to become cost conscious.

5.**Record Building:** An exhaustive documentation is necessary for the implementation of this system and it automatically leads to record building.

Demerits

1.**Lot of paper work:** It is a very detailed procedure and naturally if time consuming and lot of paper work is involved in the same.

2.**Highly Costly:** Cost involved in preparation and implementation of this system is very high.

3.**Low Morale:** Morale of staff may be very low as they might feel threatened if a particular activity is discontinued.

4.**Subjective Decision making:** Ranking of activities and decision-making may become subjective at times.

5.**Non-monetary consideration:** It may not advisable to apply this method when there are non financial considerations, such as ethical and social responsibility because this will dictate rejecting a budget claim on low ranking projects.

Q.NO.11:- Write a short note on Budget Ratios/control Ratios.

Ans:-

Ratio	Meaning	Time-Based formula	Output based formula
Budgeted capacity usage Ratio	Relationship between number of working hours and the maximum possible number of working hours in a budget period.	Budgeted hours / Practical plant capacity hours	Budgeted output / Practical plant capacity output
Actual capacity Utilisation Ratio	Indicates the extent to which facilities were actually utilized during the budget period.	(a) Actual hours / Budgeted hours, or (b) Actual hours/ possible hours	(a) Standard output / Budgeted output Or (b) Standard output / Possible output.
Efficiency Ratio	Standard hours equivalent of work produced expressed as a percentage of the actual hours spent in producing the work.	Standard hours / Actual hours	Actual output / Standard output
Calender Ratio	Relationship between the number of working days in a period and the number of working days in the relative budget period.	Actual days / Budgeted days or Possible hours /Budgeted hours	Possible output /Budgeted output
Volume or Level of activity Ratio	Number of standard hours equivalent fo work produced expressed as a percentage of the budget of standard hours.	Standard hours/ Budgeted hours	Actual output / Budgeted output