Preface to the Notes

This notes has been prepared for the benefit and use of CA Final students. Other Professional Course students can also use the material for respective topics of their syllabus. Being notes, the topics have been condensed and are presented in a synopsis manner. Yet, they cover the complete issues involved in respective topics and give the reader good understanding of the subject. This has been prepared for the ease of students preparing for Examinations. The issues have been explained in simple language supported by examples as well. If students desire to have more in-depth knowledge on any topic(s) then they need to refer relevant Text Books.

This paper of the CA Final course had substantial change in the contents and syllabus as compared to the erstwhile Advanced Management Accounting. There is a marked shift from more of the earlier Figure Work to Theory and Figure work in current syllabus. The syllabus has included more of the practical aspects of Management Accounting and Performance Evaluation with Case Studies. To answer practical cases, a student needs to have:

- Thorough understanding of the Theory;
- Application of theoretical knowledge to Practical business scenarios for solutions: and
- Figure work analysis.

In this part, only theory has been considered.

I hope this notes will be of good use to students.

Readers are requested to mail suggestions and feed back to ram_pv@rocketmail.com for improving the contents.

Good wishes and Happy Reading
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CHAPTER 11: Budgetary Control

Broad Contents of the Chapter are:

1. Budgetary Control
2. Beyond Budgeting

Budgetary Control

Budgetary Control is defined as Systematic Control of an Organisation's operations through establishment of Standards and Targets regarding Income and Expenditure, and a Continuous Monitoring and Adjustment of Performance against them.

Budgetary Control may also be defined as A System of Controlling Costs which includes the preparation of Budgets, Coordinating the Departments and Establishing Responsibilities, Comparing the Actual Performance with Budgets and Acting upon Results to achieve Maximum Profitability.

Budgetary Control is the process by which budgets are prepared for the future period and are compared with the actual performance for finding out variances, if any. The prerequisites of Effective Budgetary Control are:

A. Serious Attitude to the System;
B. Clear Demarcation between areas of Managerial Responsibility;
C. Reasonable Budget Targets;
D. Established Data Collection, Analysis, and Reporting Techniques;
E. Reports aimed at Individual Managers rather than being General;
F. Short Reporting Periods – may be a month;
G. Timely Variance Reports;
H. Action being Taken to get operations under Control in Case of Deviations.

Feedback and Feed Forward Control: Feedback and Feed Forward are 2 types of Controls schemes that react automatically to changing Business Dynamics. These 2 Control schemes can be in the same system at the same time and act simultaneously. But the 2 schemes function in different ways.

A. **Feedback** is a reaction to an action that has already taken place. So, this presupposes the existence of an error on which corrective action is to be taken.

   Feedback is defined as the Measurement of differences between planned outputs and actual outputs and the modification of subsequent action and / or plans to achieve future desired results. This is an integral part of Budgetary Control and Standard Costing Systems. Under this scheme Actual Results are simply compared with Budgeted Results.

Control Reports are the Essence of Feedback Scheme. Control Repots as such by themselves do not cause any change in performance. A change occurs only when action on Control Reports is taken and Implemented by respective Managers. Feedback reports should have the following 5 features:

a. The Report should show both Accomplishment and Responsibility.
b. Reports should be extracted promptly.
c. Reports should disclose Trends and Relationships.
d. Reports should show Variations from Standards.
e. Report Formats should be Standardised.

Limitations of Feedback Reports: The limitations are:

a. The Scheme depends heavily on success of the error detection system.
b. There could be some time lag from the time the Error is Detected, Confirmed and Corrective action is taken. Meanwhile, actual results may change again.

B. **Feed Forward Control**: Feed Forward Control is a case where the Corrective Control Mechanism is put in place before the error takes place by anticipating the error in advance. This is **Defined** as the Forecasting of differences between actual and planned outcomes and implementation of actions before the event to avoid differences. For instance, if a transport strike is expected by trucks, then alternate arrangements are made by considering Rail transport to meet Budget projections. Guidelines to be followed before implementation of Feed Forward Control are:

a. Thorough Planning and Analysis;
b. Careful selection of Input Variables;
c. The process Feed Forward should be Dynamic;
d. A Model of Control System should be in Place;
e. Action is to be taken on the issues where deviations are expected.

Limitations of Feed Forward Reports: Following are the Limitations of Feed Forward Reports:

a. Feed Forward Reports are based on Estimates and Estimates are subject to Uncertainties.
b. Study of Future is not well developed nor the tools through which they can be studied.

Budget Slack: Budget affects the behaviour of managers. These can Motivate or Demotivate Managers. Unrealistic demanding targets tend to affect manager’s performance adversely. Allowing managers to set their own targets will introduce **Slack Targets**. Managers working in an environment where they are expected to meet the budget targets often try to introduce slack into budget. Having Slack in Budgets to make achievement easier will have detrimental impact on the evaluation of actual performance.

Effect of the Budget and Difficulty in Performance: Once Budgets are put in Place, then there needs to be a system of Performance Evaluation also. The evaluation may be directly with actuals or on a prorate basis with actuals (as done in Standard Costing). Evaluation is a Sensitive issue for Employees and is subject to Criticism. Potential Difficulties are:

a. Budgets have no Motivational effect, unless they are accepted by Managers as their own Personal Targets.
b. Demanding Budgets result in better achievement of results.
c. Demanding Budgets are seen as more relevant than less difficult. But Negative attitude of employees result if the Budgets are too difficult to achieve.
d. Good Upward Communication and Departmental Meetings help in easy Acceptance of Budgets by Managers.
e. Manager's reaction to Budget Targets depends on the individual personality of the Manager and also the Culture of the Organisation.

Budget level that motivates the Best level of performance may not be achievable. Also, a budget that is expected to be achieved may result in lower level of performance by Managers as they do not aspire to meet Budget Targets. Balanced scorecard and Building Block models help in setting up of Budget Targets for various factors (both Financial and Non Financial.)

Participation in Budget Setting Process: There are 2 main approaches to Budgeting.

A. **Top to Down Approach (Imposed Style Approach)**: In this method Budgets are Centrally prepared and communicated to Managers for implementation without any discussion. Managers have no choice except accepting the Budgets. The main benefit of this type is Budgets can be framed easily and they are less time consuming. Risk is since managers' participation will not be there, the Budgets may not be accurate and the targets set may not be acceptable to the operating Managers.
B. **Bottom-up Approach (Participative Approach)**: In this method, Budgets are prepared by Operating Mangers and sent to the Management for their review and approval. After approval they are sent back to managers for implementation. As Budgets preparation has the participation of Operating Managers, their dedication to achieve the set Budget Targets will be more.

Researchers have varied views on in advocating which of the 2 is a better one. Some advocated Bottom-up approach as better and others Top to Down. So, while applying, the practicalities are to be considered and the one that suits in that scenario is to be adopted. There is no hard and fast rule. Both have their pros and cons.

Beyond Budgeting

Beyond Budgeting is a leadership philosophy that relates to an alternative approach to budgeting that is to be used instead of traditional annual budgeting. Beyond Budgeting has high degree of Adaptability and Constant Innovation whereas Traditional Budgeting Focuses on efficient usage of the limited Financial and other Resources. This concept has evolved due to following the **limitations of traditional budgeting**:

a. Time and Costly affair.
b. Constrained for Responsiveness and Flexibility
c. Often acts as a barrier to change.
d. Rarely focused strategically.
e. Adds little value, more so when the time is short.
f. Concentrates more on cost reduction than value creation.
g. Developed and updated too infrequently, usually a year.
h. Usually interpolated with previous year figures rather going into detailed computations.
i. Make people feel undervalued.

Beyond Budgeting is an idea that Firms need to have because inherent Flaws and Limitations of Traditional Budgeting. Techniques such as Rolling forecasting, market related targets are to be adopted in current dynamic business scenarios.

Beyond Budgeting has 2 important advantages:

a. This is an adaptive process; and
b. This is a decentralised process (i.e. Bottom-up Approach)

Features of Beyond Budgeting:

a. The Rolling Budgets can incorporate K P Is'
b. Benchmarking can be incorporated in Budgets
c. Focus of the Mangers shifts to improving future Results (more emphasis on Strategic Goals)
d. Operational Managers are to react to environment.
e. Encourages a culture of innovation
f. More timely allocation of resources

Suitability of Beyond Budgeting:

Beyond Budgeting will be suitable in the following Cases:

a. Industries where **Rapid Changes** take place in business environment. In these cases, flexible Budgets will be responsive to change.
b. Industries using **Management Methods** such as TQM etc. where continuous improvement will be the key.
c. Industries undergoing **Radical Changes** like implementation of BPR. In this case both fixation of Targets and achievement of them

will be difficult.

Benefits of Beyond Budgeting:

a. Helps Managers to work in coordination to beat competition. Internal rivalry shifts on to competitors.
b. Motivates Managers by defining clear responsibilities and challenges.
c. Rewards will be Team based than individual based.
d. Authority is delegated to Operational Managers who are close to the action scene. Hence decision making will be faster.
e. Operational Managers focus on Budget Ratios than the actual Budget limits.
f. Customer oriented teams are established.
g. Fast and Open Information systems are created throughout the Organisation.

Principles of Beyond Budgeting:

a. **Goals**: Inspirational Goals are to be setup aimed at Continuous Improvement and not the Annual Targets.
b. **Rewards**: Rewards of success are to be shared based on Relative Performance and not on meeting fixed Annual Targets.
c. **Planning**: Planning is to be continuous and not an annual event.
d. **Controls**: Controls are to be based on KPIs' and performance trends rather than on variances against plan.
e. **Resources**: Resources are to be need based and not by the mode of Annual Plan.
f. **Coordination**: Cross Company interactions has to be Dynamic and through Annual Planning cycles.

Leadership Principles of Beyond Budgeting:

a. **Customer**: Everyone should Focus on Customer Improvement and not on meeting Internal Targets.
b. **Accountability**: Network of teams Accountable for Results are to be created and not Centralised hierarchies.
c. **Performance**: Success means winning in Market Place and not achieving Internal Targets.
d. **Freedom to Act**: Teams are to be given Freedom and Capability to act and not just adhering to plans.
e. **Governance**: Governance is to be based on clear Values and Boundaries and not detailed Rules and Budgets.
f. **Information**: Open and Shared Information is to be promoted and not restricted to those on Need to Know Basis.

Implementation of Beyond Budgeting: Following sequential steps are involved in implementation of Beyond Budgeting:

a. Define the case for change and Outline vision is to be provided.
b. Board is to be convinced.

c. Get started.
d. Design and implement New Processes.
e. Train and Educate people in New Processes.
f. Rethink the role of Finance.
g. Change Behaviour in line with New Processes.
h. Evaluate the Benefits.
i. Consolidate the Gains.

Traditional Budgeting Vs. Beyond Budgeting:

#	Features	Traditional Budgeting	Beyond Budgeting
1	Targets	Incremental Targets	Stretch Goals & Relative Targets
2	Rewards	Fixed Rewards	Relative Rewards
3	Planning	Fixed Annual Plans	Continuous Planning
4	Controls	Variance Controls	KPIs' & Rolling Forecasts
5	Resources	Pre allocated Resources	Resources on Demand
6	Coordination	Central Coordination	Dynamic Coordination
7	Organisational Culture	Central Control & Focus on Managing Numbers	Local Controls on Goals & Focus on Value Creation

Conclusion:

a. Budgeting is alive and evolving with New Tools & Techniques rather than becoming obsolete.
b. There is a remarkable shift from Top Down process to Bottom up Process.
c. Highlights the level of improvement that can be achieved with simple modifications and great trust.
d. Budgeting has changed, neither Dramatically nor Radically. But, Traditional budgets are being supported by new tools and techniques.
e. Forecasting continues to play a key role.