



INTER 2025



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CHAPTER 15 BUDGET



Theory Chart

Chp15 Budget

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BASICS

Introduction

- Budget is a commonly used business language that expresses the **business plans** in **quantifiable terms**.
- When the **targets** are **monitored** and **compared** with the actual results with the objective to narrow down the **deviations**, make participants **responsible** and implement the **preventive and corrective actions**, is known as **budgetary control**.

Budget

- The Chartered Institute of Management Accountants (CIMA), UK defines budget as “A financial and/or **quantitative statement**, prepared and approved **prior to a defined period** of time of the policy to be pursued during that period for the purpose of attaining a given objective. It may include **income**, **expenditure** and **employment of capital**”
- The budget is a **blue-print** of the projected **plan of action** expressed in **quantitative terms** for a specified period of time.

Budget vs Forecast

- A **forecast** is an **assessment** of probable **future events**. **Budget** is a financial/quantitative **plan** of a **business enterprise** to be pursued over a period of time.
- Budget** is a **commitment** or a target which the **management** seeks to **attain** on the basis of the forecasts made. Forecasts are made regarding sales, production cost and financial requirements of the business.
- Forecast denotes some degree of **flexibility** while a budget denotes a definite target.

Budgeting

- Budgeting is the **process** of **designing, implementing and operating** of budget
- It is a means of **coordinating** the **combined intelligence** of an entire organisation into a **plan of action** based on past performance and governed by rational judgment of factors that will **influence** the course of business in the **future**.

ESSENTIAL CHARACTERISTICS OF BUDGET

- It is **concerned** for a **definite future period**.
- It is a **written** document.
- It is a **detailed plan** of all the **economic activities** of a business.
- All the **departments** of a business unit should **co-operate** for the preparation of a business budget.
- Budget is a **means** to achieve business **objectives** and it is **not an end** in itself.
- Budget needs to be **updated, corrected and controlled** every time circumstances change. Therefore, it is a **continuous process**.
- Budget helps in **planning, coordination and control**.
- Different types** of budgets are prepared by industries according to business **requirements**.
- A budget acts as a **business barometer**.
- Budget is usually prepared in the light of **past experiences**.
- Budget is a **constant endeavour** of the Management.

ESSENTIAL STEPS FOR PREPARING BUDGET

- Clear **Organisation Structure** with **division of responsibility**
- Clear **Objectives** and **Targets** in line with Co's **Vision**
- Clearly **communicated** to management and person responsible
- Prepared for **future periods** based on expected course of action
- Flexible and Adjustable** to unexpected events or changes
- Commitment** of All
- Linkage** with **Reward** System
- Periodic **Monitoring**

OBJECTIVES OF BUDGETING

Planning

- Planning is the **beginning** of any activity.
- Planning establishes the **objectives** of the firm and decides the course of **action to achieve** it
- It is concerned with formulating **short-term** and **long-term plans** to achieve a particular end.
- Planning is a statement of **what** should be done, **how** it should be done and **when** it should be **done**.
- Establishing** specific **targets** for future operations is part of the **planning function** of management, while **executing actions** to meet the goals is the **directing** function of management.
- Budget reflects plans. Therefore, **planning** should **precede** the preparation of budget.
- Budgeted plans are **quantified** and **responsibility** is **assigned** to the persons who are responsible for execution of plan.

Directing and Coordinating

- Once the budget plans are in place, these can be **used to direct and coordinate operations** in order to achieve the stated targets.
- The budget offers an important **tool to direct and coordinate business activities** and units to achieve stated targets of performance.
- Objectives** of each responsibility centre and degree of **performance expected** from them are **separately communicated**.

Controlling

- Control is the process of **monitoring, measuring, evaluating** and correcting **actual results** to ensure that a firm's goals and plans are achieved. Control is achieved through the **process of feedback**.
- As time passes, the actual performance of an operation can be **compared** against the planned targets. This provides **prompt feedback** to employees about their performance. If necessary, employees can use such feedback to **fine-tune their activities** in the future.
- Any **unforeseen changes** into the conditions which were prevailing at the time of preparing budget are taken into **account** and budgets are **revised** to show **true performance**.
- Comparing actual results to the plan helps **prevent unplanned expenditures**. The budget helps employees to regulate their **spending priorities**.

BUDGETARY CONTROL

Meaning

It is the **system of management control** and **accounting** in which all the operations are forecasted and planned **in advance** to the extent possible and the **actual results compared** with the forecasted and planned results.

Budgetary Control Involves

- Establishment of budgets
- **Continuous comparison** of actuals with budgets for achievement of targets.
- **Revision** of budgets after considering the **changes** in the circumstances.
- **Fixation** of the **responsibility** for failure to achieve the budget targets.

Objectives of Budgetary Control System

- Portraying with **precision** the **overall aims** of the business and determining **targets of performance** for each **section** or department of the business.
- Laying down the **responsibilities** of each of the **executives** and other personnel so that everyone knows what is **expected of him** and how he will be **judged**. Budgetary control is one of the few ways in which an objective assessment of executives or department is possible.
- Providing a **basis for the comparison** of actual performance with the predetermined targets and investigation of deviation, if any, of actual performance and expenses from the budgeted figures. This naturally helps in adopting **corrective measures**.
- Ensuring **optimum use of available resources** to maximise profit or production, subject to the limiting factors. Since budgets cannot be properly drawn up without considering all aspects, usually there is **good co-ordination** when a system of budgetary **control operates**.
- Co-ordinating various activities of the business, and **centralising control** and yet enabling management to **decentralise responsibility** and delegate authority in the overall interest of the business.
- Engendering a spirit of careful forethought, assessment of what is possible and an attempt at it. It leads to **dynamism** without being reckless. Of course, much depends on the objectives of the firm and the dynamism of its management.
- Providing a **basis** for revision of current and future **policies**.
- Drawing up **long range plans** with a fair measure of accuracy.
- Providing a **yardstick** against which **actual results** can be compared.

Steps for establishing Budgetary Control

- Determining the **objectives to be achieved**, over the budget period, and the **policy** or policies that might be adopted for the achievement of these objectives.
- Determining the **activities** that should be undertaken for the achievement of the objectives.
- Drawing up a **plan** or a **scheme of operation** in respect of each class of activity, in **quantitative** as well as **monetary** terms for the budget period.
- Laying out a **system of comparison** of actual performance by each person, or department with the relevant budget and **determination of causes** for the variation, if any.
- Ensuring that **corrective action** will be taken where the plan has not been achieved and, if that is not possible, for the **revision of the plan**.

Feedback and Feedforward Control

- There are two types of budgetary control system based on timing of action:
- **Feedback Control:** The feedback system of budgetary control, the actual results for the budgeted period are collected and compared with the budgeted figures. The exercise of variance identification is done after the completion of the budget period. The **variances** are **reported** and based on the report **corrective actions** are taken, **responsibility is fixed** and based on experience, **modification in future targets** is implemented. As the name suggests, it is an **Ex-post Corrective control** system of budget. Though this type of control system is **less expensive** to maintain but has limitations. Organisation has to **remain on looser side in today's age of data warfare**.
 - **Feedforward Control:** This is the opposite of feedback control system of budgetary control. It is **Ex-Ante Preventive control** mechanism of budgetary control. The budgets are set at the inception of the budgeted period and the **actual results are continuously monitored and compared**. The targets are kept realistic as far as possible and the **targets are reviewed and reset** if necessary. This system is very **expensive and beneficial** for the organisations where the business environment is dynamic and information has important role in **getting edge in competition and today's data warfare**.

Budget Committee and Budget Officer

- The budget committee is a **group of representatives of various functions** in an organisation. As all functions are **inter-related** and as any change in **one's target will have its impact** on that of the other, it is necessary to discuss the targets so that a **mutually agreed programme** is finally decided. This is called **coordination** in budget-making. It is a powerful force in knitting together various activities of the business and enforcing real control over operations.
- The **Chief Executive** is ultimately responsible for the budget programme but it will be better if the large part of the **supervisory responsibility is delegated** to an official designated as **Budget Officer**. The budget Officer should have knowledge of the technical side of the business and should report to the president or CEO of the business entity.
- The main responsibilities of the Budget Committee/Budget Officer are to:
 - **Assist** in the preparation of the **separate budget** for various departments
 - **Forward the budget** to the individual departments heads who are **responsible**
 - Prepare the periodical **budget reports**
 - **Follow-up** action to be taken on the budget reports;
 - Prepare an **overall budget** working report
 - Prepare periodical **reports**

Components of Budgetary Control System

- The policy of a business for a defined period is represented by the master budget, the detailed components of which are given in a number of individual budgets called functional budgets.
- **Physical Budgets:** Those budgets which contain information in **quantitative terms** such as the **physical units** of sales, production etc. This may include quantity of sales, quantity of **production, inventories, and manpower** budgets are physical budgets.
 - **Cost Budgets:** Budgets which provides **cost information** in respect of manufacturing, administration, selling and distribution, etc. for example, manufacturing costs, selling costs, administration cost, and research and development cost budgets are cost budgets.
 - **Profit Budgets:** A budget which enables the **ascertainment of profit**. For example, sales budget, profit and loss budget, etc.
 - **Financial Budgets:** A budget which facilitates in ascertaining the **financial position** of a concern, for example, **cash** budgets, **capital expenditure** budget, budgeted balance sheet etc.

BUDGETARY CONTROL

Advantages of Budgetary Control System

Efficiency	The use of budgetary control system enables the management of a business entity to conduct its business activities in an efficient manner .
Control on expenditure	It is a powerful instrument used by business entity for the control of their expenditure . It provides a yardstick for measuring and evaluating the performance of individuals and their departments.
Finding deviations	Budget reveals the deviations of the actual from the budgeted figures after making a comparison and communicating the deviation to mgt.
Effective utilisation of resources	Like men, material, machinery and money is made possible, as the production is planned after taking these into account.
Revision of plans	Budget helps in the review of current trends and framing of future policies.
Implementation of Standard Costing	Budget creates suitable conditions for the implementation of standard costing system in a business organisation.
Cost Consciousness	Budgetary control system encourages cost consciousness and maximum utilisation of available resources .
Credit Rating	Management which has developed a well-ordered budget plans and which operate accordingly , receive greater favour from credit agencies .

Limitations of Budgetary Control System

Based on Estimates	Budgets are based on a series of estimates , which are based on the conditions prevalent or expected at the time budget is established. It requires revision in plan if conditions change.
Time factor	Budgets cannot be executed automatically . Some preliminary steps are required to be accomplished before budgets are implemented. It requires proper attention and time of management . Management must not expect too much during the initial development period.
Co-operation Required	Staff co-operation is usually not available during the initial budgetary control exercise. In a decentralised organisation, each unit has its own objective and these units enjoy some degree of discretion . In this type of organisation structure, coordination among different units is required. The success of the budgetary control depends upon willingness.
Expensive	The implementation of budget is somewhat expensive as proper organisation structure with responsibility is prerequisite. It consumes valuable resources (in terms of qualified manpower, equipment, etc.) for this purpose; hence, it is an expensive process.
Not a substitute for mgt.	Budget is only a managerial tool and must be intelligently applied for management to get benefited. Budgets are not a substitute for good management.
Rigid document	Budgets are sometime considered as rigid documents. In reality, an organisation is exposed to various uncertain internal and external factors. Budget should be flexible enough to incorporate ongoing developments affecting the very purpose of the budget.

BUDGETS AND MOTIVATION

Motivation

When pursuing some target, the **end result** of achieving the goal **should be motivating** one. Motivation is a factor which works like **fuel** to get hope lighted and ignites aspirations. Therefore, motivation is the **driving force** which converts the efforts into results and thus the long-term objectives of the any person whether it would be an individual or a corporate. There **must be something motivating** in achieving the targets.

Considerations to make budget motivating

Performance measurement	the achievement of targets should have consideration in measurement and evaluation of performance an executive at individual level and at departmental level. Rewards such as promotion, increment , Performance related pay, bonus may be appropriate motivation factors.
Achievable Targets	The targets should be balance one, it neither be very easy nor too tough, means it should be realistic one.
Optimum utilisation of resources	Pressure sometime forcing to explore innovative ways to get things done. Thus, to keep motivation alive, a balanced approach should be applied for optimum utilisation of resources upto its effort zone, though beyond the comfort zone .
Involvement in budgeting process	The participative budgeting motivates the executives and give them a sense of ownership . Involvement at planning stage of budget can take care of the requirements of the executives and force them accept the targets.

PREPARATION OF BUDGETS

Defining business or organisational objectives

The organisational objectives should be **written down**; the **areas of control** demarcated; and **items** of revenue and expenditure **to be covered** by the budget clearly stated

Identification of the key budget factor

There are usually **one or two** key budget factors (sometimes there may be more than two) which **set a limit** to the total activity like **demand or production capacity**. It must be identified & should be considered in budget.

Appointment of controller/officer

Formulation of a budget usually **requires** service of a **whole time senior executive**. The Budget Controller/Officer is responsible for **coordinating and development** of budget programmes and preparing the manual of instruction, known as **Budget Manual**

Budget Manual

- It is a **booklet** specifying the **objectives** of an organisation in relation to its strategy. As per CIMA It is a **document** which **sets out** the **responsibilities** of the persons engaged in, the **routine** of, and the **forms and records required** for, budgetary control.
- **Contents of Budget Manual:**
 - A statement regarding the **objectives** of the organisation and **how they can be achieved** through budgetary control;
 - A statement about the **functions and responsibilities** of each executive, both regarding **preparation** and **execution** of budgets;
 - **Procedures** to be followed for obtaining the necessary **approval** of budgets. The **authority** of granting approval should be stated in explicit terms.
 - A form of **organisation chart** to show who are responsible for the preparation of each functional budget and the way in which the budgets are **interrelated**.
 - A **timetable** for the preparation of each budget.
 - The manner of **scrutiny** and the personnel to carry it out;
 - **Reports**, statements, forms and other **record** to be maintained;
 - The accounts classification to be employed.
 - The **reporting** of the **remedial** action;
 - the **manner** in which budgets, after acceptance and issuance, are to be **revised** or the matter amended these are included in budgets and on which action can be taken only with the approval of top management
 - This will **prevent** the formation of a '**bottleneck**' with the late preparation of one budget holding up the preparation of all others.
 - Copies of all forms to be completed by those responsible for preparing budgets, with explanations concerning their completion.
 - A list of the organization's **account codes**, with full explanations of **how to use** them.
 - Information concerning **key assumptions** to be made by managers in their budgets, for example the rate of inflation, key exchange rates, etc.

Budget period

There is **no** general **rule** governing the selection of the budget period. Normally, a **calendar year** or a period co-terminus with the **financial year** is adopted. it may be **monthly or quarterly** or for such periods as coincide with period of trading activity of the business.

Standard of activity or output

The past usually represents a combination of good and bad factors. Therefore, though results of the **past** should be studied, but these should only be **applied** when there is a **likelihood of similar** conditions repeating in the future. Therefore, what was **good in the past** is only fair for the current year and should work for much better in the future.

Special Note

In budgeting, fixing the budget of sales, expenses, and of capital expenditure is important since these budgets determine the **extent of development activity**. For budgeting sales, one must **consider the trend of economic activity** of the **country**, recommendations of salesmen, customers and employees, effect of price changes on sales, the provision for advertisement campaign plan capacity etc.

BUDGET BASED ON CAPACITY OR FLEXIBILITY

Fixed Budget

- A budget prepared on the basis of standard or **fixed level of activity** is known as fixed budget.
- It is a budget designed to **remain unchanged** irrespective of the level of activity actually attained.
- It shows the **expected results** of a responsibility center for only **one activity level**
- **Essential Conditions** to use Fixed Budget:
 - When the nature of business is **not seasonal**.
 - There is **no impact of external factors** on the business activities.
 - The **demand** of the product is **certain and stable**.
 - Supply **orders** are received and issued **regularly**.
 - The **market** of the product is normally **domestic** but it can also apply in respect of service export, where fairly regular export orders are received
 - There is **no need of special** labour or material in the production of the products.
 - Supply of production inputs is regular.
 - There is a trend of **price stability**.
- Generally, all above conditions are **not found in practice**. Hence fixed budget is not suitable in business concerns.
- **Merits:**
 - Very **simple** to understand
 - Less time consuming
- **Demerits:**
 - It does **not suite** a **dynamic** organization and may give **misleading results**. A poor or good performance may remain un-noticed.
 - It is not suitable for **long period**.
 - It is also found unsuitable particularly when the **business conditions are changing** constantly
 - Accurate estimates are not possible.

Fixed Budget

- **Meaning:** A flexible budget is a budget which, by **recognizing the difference in behaviour** between fixed and variable costs in relation to fluctuations in output, turnover, or other variable factors, is **designed to change appropriately** with such fluctuations
- **Suitability for flexible budget:**
 - **Seasonal fluctuations** in sales and/or production, for example in soft drinks industry;
 - a company which keeps on introducing **new products** or makes changes in the **design** of its products frequently;
 - industries engaged in **make-to-order business** like ship building;
 - an industry which is influenced by **changes in fashion**; and
 - **general changes** in sales.
- **Merits:**
 - **sales, costs and profit** may be calculated easily by the business at **various levels** of production capacity.
 - In flexible budget, **adjustment is very simple** according to change in business conditions.
 - Mgt. can **easily select the level of production** which shows the profit predetermined by the owners of the business.
 - It also shows the **quantity of product to be produced** to earn determined profit.
- **Demerits:**
 - The formulation of flexible budget is **possible only** when there is **proper accounting system** maintained, perfect **knowledge about the factors** of production and various business circumstances is available.
 - Flexible Budget also **requires** the system of **standard costing** in business.

FIXED AND FLEXIBLE BUDGETS

FIXED BUDGETS

It does **not change with actual volume** of activity achieved. Thus, it is known as **rigid or inflexible** budget.

It operates on **one level of activity** and under one set of conditions. It **assumes** that there will be **no change** in the prevailing **conditions**, which is unrealistic.

Here as **all costs** like - fixed, variable and semi-variable are **related to only one level** of activity so variance analysis does not give useful information.

If the budgeted and actual activity **levels differ significantly**, then the aspects like cost ascertainment and price fixation do **not give a correct picture**.

Comparison of actual performance with budgeted targets will be **meaningless** specially when there is a **difference** between the **two activity levels**.

FLEXIBLE BUDGETS

It can be **re-casted** on the basis of activity level to be achieved. Thus, **it is not rigid**.

It consists of **various budgets** for **different** levels of activity.

Here **analysis of variance** provides **useful information** as each cost is analysed according to its behaviour.

Flexible budgeting at different levels of activity **facilitates the ascertainment of cost, fixation of selling price and tendering of quotations**

It provides a **meaningful basis** of comparison of the actual performance with the budgeted targets

FUNCTIONAL BUDGETS

Sales Budget

- Sales forecast is the **commencement** of budgeting and hence sales budget assumes **primary** importance.
- The quantity which can be sold may be the **principal budget factor** in many business undertakings.
- The sales budget is prepared for **each product** which includes **quantity** of estimated sales and expected unit **selling price**.
- In estimating the quantity of sales for each product, **past sales** volumes are often used as a **starting point** and adjusted for **expected factors** that affect future sales like
 - **Backlog** of unfulfilled sales orders
 - Planned **advertising** and promotion
 - Expected industry and general **economic conditions**
 - Productive **capacity**
 - Projected **pricing**
 - Findings of **market research** studies
 - Relative product **profitability**.
 - **Competition**
- Sales budget is not merely a sales forecast. A budget is a planning and control document which shows what the management intends to accomplish. Thus, the sales budget is **active** rather than passive document.
- A **forecast** reflects the environmental or competitive **situation** facing the company whereas the sales **budget** shows how the management **intends to react** to this environmental and competitive situation.

Plant Utilisation Budget

- Plant utilisation budget represents, in terms of **working hours, weight** or other convenient **units of plant facilities** required to carry out the programme laid down in the production budget.
- Main purpose of this budget are:
 1. To determine the **load** on each process, cost or groups of machines for the budget period.
 2. To **indicate** the processes or cost centres which are **overloaded** so that **corrective action** may be taken such as: (i) working overtime (ii) sub-contracting (iii) expansion of production facility, etc.
 3. To **dovetail** (balance) the **sales production budgets** where it is not possible to increase the capacity of any of the overloaded processes.
 4. Where surplus capacity is available in any of the processes, to make effort to **boost sales** to utilise the surplus capacity.

Production Budget

- Production Budget is a **forecast** of the production for the budget period of an organization.
- Production budget shows the production for the budget period **based upon**:
 - Sales budget,
 - Production capacity of the factory,
 - Planned increase or decrease in finished stocks, and
 - Policy governing outside purchase.
- It is a **physical** budget, so number of units to be manufactured to meet budgeted sales and inventory needs for each product is set forth in the production budget.
- The production **facility** available and the **sales budget** will be **compared** and coordinated to determine the production budget. If production facilities are **not sufficient**, consideration may be given to such factors as working **overtime**, introducing **shift working**, sub-contracting or purchasing of additional plant and machinery. If, however, the production facilities are **surplus**, consideration should be given to promote **advertising**, reduction of prices to increase the sales, sub-contracting of surplus capacity, etc.
- **Level of Stocks** will depend upon the following three factors:
 - Seasonal industries in which stocks have to be **built up** during off season to **cater to the peak** season
 - A **steady and uniform** level of production to utilise the plant fully and to avoid retrenchment or lay-off of the workers, and
 - To produce in such a way that **minimum stocks** are maintained at any time to avoid locking up of funds in inventory.

Direct Material Usage Budget & Purchase Budget

- **Material Usage:** It includes the **physical units** of each Raw Material based on the production budget and corresponding rate to also show the cost. Here we need to **consider quality standards and normal loss** also.
- **Material Purchase:** It is based on material usage budget and **adjusted with planned inventories** to get budgeted purchase quantities. Considerations should be given to ROQ, Re-order Level.

Labour Cost Budget

- Based on Production Budget we can **estimate hours requirement** of different grades of labour to produce the same.
- Budgeted hours can be used to calculate **number of workers required** and then Wages Budget by multiplying their hours with wage rate.
- **Merits/ advantages:**
 - It defines the direct and indirect labour force required.
 - It enables the **personnel** department to **plan** ahead in **recruitment and training** of workers so that labour turnover can be reduced to the minimum.
 - It reveals the labour cost to be incurred in the manufacture, to facilitate preparation of manufacturing cost budgets and cash budgets for financing the wage bill.

Production or Factory Overhead Budget

- Factory overhead budget usually **includes** the **total estimated cost** for **each item** of factory overhead.
- A **few examples** are given below to show how the expenses are estimated.
 - **Fixed expenses** are normally **policy** costs and hence they are based on policy matters.
 - For estimating **indirect labour**, work study is resorted to and a estimate of number of indirect workers required for each level of direct workers employed is made - for example, **one supervisor for every twenty direct** workers.
 - In regard to the estimate of consumption of **indirect materials**, the **age and condition of the plant** and machinery are taken into consideration.

Production Cost Budget

- Production cost budget covers direct material cost, direct labour cost and manufacturing expenses.
- After preparing direct material, direct labour and production overhead cost budget, one can prepare production cost budget.

Ending Inventory Budget

- This budget shows the cost of **closing stock** of raw **materials and finished goods**, etc. required **to be maintained** by the business entity.
- This information is required to prepare cost-of-goods-sold budget and **budgeted financial statements** i.e., budgeted income statement and budgeted balance sheet.

FUNCTIONAL BUDGETS

Selling and Distribution Cost Budget

- All expenses connected with **advertising, sales promotion, sales office, salesmen, credit collection, market research, after sales service**, etc. are generally **grouped** together to form part of the responsibility of the sales manager.
- While making a budget, selling costs are divided into **fixed and variable**. Semivariable costs should also be separated into variable and fixed elements.
- The **problems** faced in the preparation of **selling cost budgets** are:
 - Heavy **expenditure on selling and sales promotion** may have to be incurred when the volume of sales is falling off
 - Sometimes intensive **sales and promotion efforts** are called for in one year and the benefit of such efforts accrue in the **subsequent** years.
 - In spite of these problems, some relationship between selling cost and volume of sales has to be established and it is the duty of the **Budget Controller** to determine the amount of selling costs to be incurred to achieve the desired level of sales volume.
- When preparing the **advertisement cost** budget, consideration should be given to the following factors:
 - The **best method** of advertisement must be selected; costs will vary according to the method selected.
 - The **maximum amount** to be spent in a period, say one year, has to be decided.
 - Advertising and sales should be co-ordinated.
 - An **effective control** over advertisement expenditure should be exercised and the **effectiveness** of the advertisement should be measured.

Administrative Expenses Budget

- The administrative expenses are mostly **policy costs** and are, therefore, **fixed** in nature.
- The most **practical** method to follow in preparing estimate of these expenses is to follow the **past experience** with due regard to **anticipated changes** either in general policy or the volume of business.
- Examples of such expenses are: **board meeting** expenses, expenditure incurred on **staff employed in human resources** and **finance** departments, **audit** fees, depreciation of office equipment, insurance, subscriptions, postage, stationery, telephone, telegrams, office supplies, etc

Research and Development Cost Budget

- Research is required in order to **develop and/or improve** products and methods.
- When research results in **definite benefit** to the company, **development** function **begins**.
- After development, **formal production** can commence on commercial scale and then production function starts.
- Research and Development (R & D) plays a vital role in maintaining the business. For example, **automobile** manufacturers, and those who **produce drugs**, spend considerable sums on R&D to improve their products.
- Research and development expenses should be **controlled carefully** and hence a **limit** on the spending is placed, i.e., the amount to be spent is carefully determined or allocated.

Capital Expenditure Budget

- The capital expenditure budget represents the planned **outlay on fixed assets** like land, building, plant and machinery, etc. during the budget period.
- This budget is subject to **strict management control** because it entails **large amount** of expenditure.
- The preparation of capital budget is **based on** the following considerations:
 - **Future development plans** to increase output by expansion of plant facilities.
 - **Replacement requests** from the concerned departments.
 - Actors like **sales potential** to absorb the increased output, possibility of price reductions, increased costs of advertising and sales promotion to absorb increased output, etc.
- **Merits/ Advantages of Capital Budgeting:**
 - It enables the company to establish a **system of priorities**.
 - It serves as a **tool for controlling** expenditure.
 - This enables the **cash budget** to be completed.
 - It facilitates cost reduction programme, particularly when modernisation and renovation is covered by this budget.

Cash Budget

- Cash Budget is a detailed budget of **cash receipts** and cash **payments** incorporating both revenue and capital items for the budget period.
- This budget is usually of **two parts** giving detailed estimates of (i) cash receipts and (ii) cash disbursements.
- It is the plan of receipts and payments of cash for the budget period, **analysed** to show the **monthly flow of cash drawn up** in such a way that the balance can be forecasted at regular intervals.
- **Main objectives** of cash budget:
 - The **probable cash position**, as a result of planned operation, is assessed;
 - This helps in **arranging short-term borrowings in advance** to meet the situations of shortage of cash or making investments when cash is in excess.
 - Cash can be coordinated in relation to total working capital, sales investment and debt.
 - A **sound basis** for credit for current **control of cash** position is established.

MASTER BUDGET

Meaning

- The **summary budget**, incorporating its component functional budgets, which is **finally approved**, adopted and employed.
- When all the necessary functional budgets have been prepared, the **budget officer** will prepare the master budget which may consist of **budgeted profit and loss account and budgeted balance sheet**.

BUDGET CLASSIFICATION BASED ON TIME PERIOD

Long term Budget

- Long Term Budget is a budget prepared covering a **period of more than a year**.
- The Budgets are prepared to depict **long term planning** of the business.
- The period of long-term Budgets varies between **three to ten** years.
- These budgets are useful for those industries where **gestation period is long** i.e., the business entities **manufacturing machinery, electricity** etc.

Short term Budget

- These budgets are generally for **one or two years** and are in the form of monetary terms.
- The **consumer's good industries** like Sugar, Cotton, and textile use short term budgets.

Current Budgets

- The period of current budgets is generally of **months and weeks**.
- These budgets relate to the **current activities** of the business.

ZERO BASED BUDGETING (ZBB)

Meaning

- Zero-based Budgeting (ZBB) is defined as a method of budgeting which **requires** each **cost element** to be specifically **justified**, though the activities to which the budget relates are **not** being undertaken for the **first time**.
- The cost of each activity has to be justified and **without justification**, the **budget** allowance is **zero**.
- ZBB is an activity-based budgeting system where **budgets** are prepared for **each activity** rather than functional department.
- ZBB is **suitable** for both **corporate and non-corporate** entities.
- In case of non-corporate entities like Government department, local bodies, **not for profit** organisations, where these entities need to **justify the benefits of expenditures** on social programmes like mid-day meal, installation of street lights, provision of drinking water etc.
- In case of **corporate** entities, ZBB is best **suited** for **discretionary costs** like research and development cost, training programmes, advertisement etc.

Stages in Zero-based Budgeting

Identification and description of Decision packages	Decision packages are the programmes or activities for which decision is required to be taken. The programmes or activities are described for technical specifications, financial impact in the form of cost benefit analysis and other issues like environmental, regulatory, social etc.
Evaluation of Decision packages	Once Decision packages are identified and described, it is evaluated against factors like synchronisation with organisational objectives , availability of funds, regulatory requirement etc.
Ranking (Prioritisation) of the Decision packages	After evaluation of the decision packages, it is ranked on the basis priority of the activities. Because of this prioritization feature ZBB is also known as Priority-based Budgeting .
Allocation of resources	After ranking of the decision packages, resources are allocated for decision packages. Budgets are prepared like it is done first time without taking reference to previous budgets.

Advantages of Zero-based Budgeting

- It provides a **systematic approach** for the evaluation of different activities and rank them in order of preference for the allocation of scarce resources.
- It ensures that the various **functions** undertaken by the organization **are critical** for the achievement of its objectives and are being **performed in the best possible way**.
- It provides an opportunity to the management to **allocate resources** for various activities only after having a thorough **cost-benefit-analysis**. The chances of arbitrary cuts and enhancement are thus avoided.
- The areas of **wasteful expenditure** can be easily identified and **eliminated**.
- Departmental budgets are closely linked with corporation objectives.
- The technique can also be used for the introduction and **implementation of the system of 'management by objective'**

Traditional Budgeting vs ZBB

- Traditional budgeting is **accounting oriented**. Main stress happens to be on **previous level of expenditure**. Zero-based budgeting makes a **decision-oriented** approach.
- In traditional budgeting, **first reference** is made to **past** level of spending and then demand for inflation and new programmes. In zero-based budgeting, management focuses **attention to only on decision packages**, which enjoy priority to others.
- In tradition budgeting, some managers **deliberately inflate their budget request** so that after the cuts they still get what they want. In zero-based budgeting, a **rationale analysis** of budget proposals is attempted.
- Traditional budgeting is not as clear and as responsive as zero based budgeting.

Limitations of ZBB

- The work involves in the **creation of decision-packages** and their subsequent **ranking** has to be made on the basis of new data. This process is very **tedious** to management.
- The activities selected for the purpose of ZBB are on the basis of the traditional functional departments. So, the consideration scheme may not be implemented properly.

BUDGET RATIOS

Meaning

- Budget ratios provide information about the **performance level**, i.e., the extent of deviation of actual performance from the budgeted performance and whether the actual performance is favourable or unfavourable.
- If the ratio is **100% or more**, the performance is considered as **favourable** and if ratio is less than 100% the performance is considered as unfavourable.

PERFORMANCE BUDGETING

Meaning

- Performance budgeting requires **fixing of the responsibility** of each **executive** in organisation and the **continuous appraisal** of his performance.
- It is, therefore, considered to be synonymous with **responsibility accounting**
- Programmes and activities are correlating the physical and financial aspect of the individual items comprising the budget.

Traditional Budgeting vs. Performance Budgeting

- The traditional budgeting gives **more emphasis** on the **financial aspect** than the physical aspects or performance.
- 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 emphasis is more on the functions of the organisation**, the programmes to discharge this function and the activities which will be involved in undertaking these programmes.

Steps in Performance Budgeting

- According to the Administrative Reforms Commission (ARC), the following **steps** are the basic ones in PB:
- Establishing a **meaningful functional programme** and **activity classification** of government operations.
 - Bring the system of **accounting and financial management** in accordance with this classification.
 - Evolving suitable norms, yardsticks, work units** of performance and units costs, wherever possible under each programme and activity for their **reporting and evaluation**.

Pre-requisites to adopt PB

- the **objectives** of the enterprise are spelt out in **concrete terms**.
- the **objectives** are then translated into **specific functions, programmes, activities and tasks** for different levels of management within the realities of fiscal constraints;
- realistic and acceptable **norms, yardsticks or standards** and performance indicators should be **evolved** and expressed in quantifiable physical units.
- a style of management based upon **decentralised responsibility structure** should be adopted, and
- an accounting and **reporting system** should be developed to facilities **monitoring, analysis and review** of actual performance in relation to budgets.

consideration in drawing up of performance reports

Significance	Are the facts in the reports reliable? Does it either called for action or demonstrate the effect of action?
Timeliness	How late can the information be and still be of use? What is the earliest moment at which it could be used if it were available? How frequently is it required?
Accuracy	How small should be an inaccuracy which does not alter the significance of the information?
Appropriateness	Is the recipient the right person to take any action that is needed? Is there any other information which is required to support the information to anyone else jointly interested?
Discrimination	Will anything be lost by omitting the item? Will any of the items gain from the omission? Is the responsibility for suppressing the item acceptable?
Presentation	Is the report clear and unbiased? Is the form of it is suitable to the subject? Is the form of it suitable to the recipient?

Types of reports

Top Management	Balance Sheet, Profit & Loss Statement, Position of stocks, Disposition of funds or working capital, Capital expenditure and forward commitments together with progress of projects in hands, Cash-flow statements, Sales, production, and other appropriate statistics.
Sales Management	- Actual sales compared with budgeted sales to measure performance and selling expenses by – Products, Territories, Salesman, Customers - Standard profit and loss by product for fixing prices and concentrate on more profitable products - Bad debts and accounts which are slow and difficult in collection. - Status reports on new or doubtful customers.
Production Management	To Foreman: Operational efficiency for individual operators duly summarized as departmental average; Labour utilization report and causes of lost time and controllable time; Indirect shop expenses against the standard allowed and scrap report To Works Managers: Departmental operating statement; Plant utilization report; Department Scrap report; Material usage report.
Special Reports	These reports may be prepared at the request of general management or at the initiative of the management accountants. Some of the matters in respect of which such reports may be required can be: - Taxation legislation and its effect on profits. - Estimates of the earning capacity of a new project. - Break-even analysis - Replacement of capital equipment. - Make or buy certain components