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Theory Q&A

Chp15 Budget

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Chp15. Budget

Theory Notes

(b) Define the following terms:

(i) Controllable Variance

(ii) Uncontrollable Variance

(iii) Budget Manual

(iii) Performance Budgeting

(iv) Budget Period

(5 Marks)

- (b) (i) **Controllable variances:** Controllable variances are those which can be controlled under the normal operating conditions if a responsibility centre takes preventive measures and acts prudently. Responsibility centres are answerable for all adverse variances which could have been controlled.
- (ii) **Uncontrollable variances:** Uncontrollable variances are those which occurs due to conditions which are beyond the control of a responsibility centre and cannot be controlled even though all preventive measures are in place.
- (iii) **Budget Manual:** The budget manual is a booklet specifying the objectives of an organisation in relation to its strategy. The budget is

made to decide how much an organisation would earn and spend and in what manner. In the budget, the organisation sets its priorities too.

Budget manual is also defined as, "A document which sets out the responsibilities of the persons engaged in, the routine of, and the forms and records required for, budgetary control."

Effective budgetary planning relies on the provision of adequate information to the individuals involved in the planning process. Many of these information needs are contained in the budget manual. A budget manual is a collection of documents that contains key information for those involved in the planning process.

(iv) Performance budgeting: Performance budgeting (PB) involves evaluation of the performance of an organisation in the context of both specific as well as overall objectives of the organisation.

Performance Budgeting provide a meaningful relationship between estimated inputs and expected outputs as an integral part of the budgeting system. A performance budget is one which presents the purposes and objectives for which funds are required, the costs of the programmes proposed for achieving those objectives, and quantitative data measuring the accomplishments and work performed under each programme. Thus, PB is a technique of presenting budgets for costs and revenues in terms of functions. Programmes and activities correlate the physical and financial aspect of the individual items comprising the budget.

(v) Budget period: The period covered by a budget is known as budget period. There is no general rule governing the selection of the budget period. In practice the Budget Committee determines the length of the budget period suitable for the business. Normally, a calendar year or a period co-terminus with the financial year is adopted. The budget period for the calendar or financial year is then divided into shorter periods; it may be monthly or quarterly or for such periods as coincide with period of trading activity of the business.

(c) *Discuss Feedback Control and Feedforward Control system of budgetary control.*

(c) 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.

This system of budgetary control is common in organisations where Management Information System (MIS) is not so robust and where data is obtained only after the finalisation of books of account. Though this type of control system is less expensive to maintain but has limitations.

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 budgetary control system requires a robust MIS supported by integrated ERP system enabling an entity to get data as and when desired basis. 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.

(d) Define Budget Manual. What are the salient features of Budget Manual?

(d) Budget Manual: The budget manual is a booklet specifying the objectives of an organisation in relation to its strategy. The budget is made to decide how much an organisation would earn and spend and in what manner. In the budget, the organisation sets its priorities too.

Effective budgetary planning relies on the provision of adequate information to the individuals involved in the planning process. Many of these information needs are contained in the budget manual. A budget manual is a collection of documents that contains key information for those involved in the planning process.

CIMA London defines budget manual as, 'A document which sets out the responsibilities of the persons engaged in, the routines of, and the forms and records required for, budgetary control'.

Contents of a budget manual: Typical budget manual may include the following:

- (i) A statement regarding the objectives of the organisation and how they can be achieved through budgetary control;
- (ii) A statement about the functions and responsibilities of each executive, both regarding preparation and execution of budgets;
- (iii) Procedures to be followed for obtaining the necessary approval of budgets. The authority of granting approval should be stated in explicit terms. Whether, one two or more signatures are required on each document should be clearly stated;
- (iv) 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.
- (v) A timetable for the preparation of each budget.
- (vi) The manner of scrutiny and the personnel to carry it out;
- (vii) Reports, statements, forms and other record to be maintained.

- (viii) The accounts classification to be employed. It is necessary that the framework within which the costs, revenue and other financial accounts are classified must be identical both in the accounts and budget department.
- (ix) The reporting of the remedial action.
- (x) The manner in which budgets, after acceptance and issuance, are to be revised or amended, these are included in budgets and on which action can be taken only with the approval of top management
- (xi) This will prevent the formation of a 'bottleneck' with the late preparation of one budget holding up the preparation of all others.
- (xii) Copies of all forms to be completed by those responsible for preparing budgets, with explanations concerning their completion.
- (xiii) A list of the organization's account codes, with full explanations of how to use them.
- (xiv) Information concerning key assumptions to be made by managers in their budgets, for example the rate of inflation, key exchange rates, etc.

(Any four points)

(d) *What is 'Budgetary Control System' and discuss the components of the same.*

- (d) **Budgetary Control System:** 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.

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. These functional budgets are broadly grouped under the following heads:

1. **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.

2. **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.
3. **Profit budgets:** A budget which enables the ascertainment of profit. For example, sales budget, profit and loss budget, etc.
4. **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.

(b) *State the limitations of Budgetary Control System.*

(b) **Limitations of Budgetary Control System**

Points	Description
1. 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.
2. 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.
3. 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 willing co-operation and teamwork,

4. Expensive	The implementation of budget is somewhat expensive. For successful implementation of the budgetary control, proper organisation structure with responsibility is prerequisite. Budgeting process start from the collection of information to for preparing the budget and performance analysis. It consumes valuable resources (in terms of qualified manpower, equipment, etc.) for this purpose; hence, it is an expensive process.
5. Not a substitute for management	Budget is only a managerial tool and must be intelligently applied for management to get benefited. Budgets are not a substitute for good management.
6. Rigid document	Budgets are sometime considered as rigid documents. But in reality, an organisation is exposed to various uncertain internal and external factors. Budget should be flexible enough to incorporate ongoing developments in the internal and external factors affecting the very purpose of the budget.

(b) What are the important points an organization should consider if it wants to adopt Performance Budgeting?

(b) For an enterprise that wants to adopt Performance Budgeting, it is thus imperative that:

- 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.

(e) *Define Zero Base Budgeting and mention its various stages.*

(e) **Zero-based Budgeting:** (ZBB) is an emergent form of budgeting which arises to overcome the limitations of incremental (traditional) budgeting system. Zero-based Budgeting (ZBB) is **defined** as 'a method of budgeting which requires each cost element to be specifically justified, although the activities to which the budget relates are being undertaken for the first time, without approval, the budget allowance is zero'.

ZBB is an activity based budgeting system where budgets are prepared for each activities rather than functional department. Justification in the form of cost benefits for the activity is required to be given. The activities are then evaluated and prioritized by the management on the basis of factors like synchronisation with organisational objectives, availability of funds, regulatory requirement etc.

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.

ZBB involves the following stages:

- (i) Identification and description of Decision packages
- (ii) Evaluation of Decision packages
- (iii) Ranking (Prioritisation) of the Decision packages
- (iv) Allocation of resources

(e) Explain 'Activity Based Budgeting'.

(e) Activity Based Budgeting (ABB)

- Activity based budgeting analyse the resource input or cost for each activity.
- It provides a framework for estimating the amount of resources required in accordance with the budgeted level of activity.
- Actual results can be compared with budgeted results to highlight both in financial and non-financial terms those activities with major discrepancies from budget for potential reduction in supply of resources.
- It is a planning and control system which seeks to support the objectives of continuous improvement.
- It means planning and controlling the expected activities of the organization to derive a cost-effective budget that meet forecast workload and agreed strategic goals.
- ABB is the reversing of the ABC process to produce financial plans and budgets.

(c) *Why is 'Zero Base Budgeting' (ZBB) considered superior to 'Traditional Budgeting'? Explain.*

(c) **Zero based budgeting is superior to traditional budgeting:** Zero based budgeting is superior to traditional budgeting in the following manner:

- It provides a systematic approach for evaluation of different activities.
- It ensures that the function undertaken are critical for the achievement of the objectives.
- It provides an opportunity for management to allocate resources to various activities after a thorough – cost benefit analysis.
- It helps in the identification of wasteful expenditure and then their elimination. It facilitates the close linkage of departmental budgets with corporate objectives.
- It helps in the introduction of a system of Management by Objectives