Budgeting and Budgetary Control

Budgeting: Basics

Core concept: **Quantitative plan** of **future** activities and objectives for a specified period.

Main focus: Planning, coordination, resource allocation and performance targets.

Objectives: **Planning → Coordination → Communication → Resource allocation → Cost control → Performance evaluation → Corrective action**.

Major advantages: Better planning, cost control, efficiency, accountability and coordination.

Major limitations: Estimates may be inaccurate; preparation is time-consuming; rigidity and budgetary slack may arise.

Key distinction: Budgeting = preparation of plans; Budgetary Control = comparison, variance analysis and corrective action.

Key distinction: Budget = planned target; Forecast = expected future outcome.

Budgetary Control Process

Core concept: System of controlling operations through budgets, **actual-performance comparison** and **corrective action**.

Key process: **Objectives → Budget Centres → Key Budget Factor → Budget Policies → Functional Budgets → Master Budget → Approval → Actual Results → Variance Analysis → Corrective Action**.

Budget Centre: Organisational unit for which a separate budget is prepared.

Key Budget Factor: Limiting factor governing activity; may be sales, material, labour or capacity.

Management by Exception: Focus on significant deviations.

Budgetary Control Process (cont)

Prerequisites: Management support, clear responsibilities, realistic budgets, reliable accounting, coordination and timely reporting.

Key distinction: Budgeting prepares the plan; budgetary control monitors and acts on performance.

Budget Committee and Budget Manual

Budget Committee: Group of senior executives responsible for overall coordination, review and supervision of budgeting.

Composition: CEO/MD, Finance Director, Budget Officer and departmental heads.

Main functions: **Budget policies → Coordination → Review → Conflict resolution → Monitoring → Revision**.

Budget Officer: Administrative and technical coordinator who collects, checks and consolidates budget estimates.

Budget Manual: Written document containing budgeting procedures, responsibilities, formats, timetables and reporting guidelines.

Major distinction: Committee = People who oversee budgeting; Manual = Document explaining how budgeting is conducted.

Fixed and Flexible Budgets

Fixed Budget: Prepared for **one predetermined activity level**; does not change with actual output.

Flexible Budget: **Adjusted** according to **actual or expected activity levels**.

Main focus: Understanding how costs behave as activity changes.

Major strength of flexible budgeting: Meaningful cost control and performance evaluation at different activity levels.

Fixed and Flexible Budgets (cont)

Major weakness: Requires reliable cost classification and more preparation.

Key distinction: Fixed = one activity level; Flexible = multiple activity levels.

Cost behaviour:
- **Fixed** → Total constant; per-unit cost decreases.
- **Variable** → Total changes proportionately; per-unit cost constant.
- **Semi-variable** → Contains fixed and variable components.

Key formulas:
- Total variable cost = Variable cost per unit × Output.
- Total cost = Fixed cost + Variable cost.
- Semi-variable cost = **(a+bX)**.
- **High-Low variable cost per unit = Change in cost ÷ Change in activity**.

Functional Budgets

Core concept: **Separate budgets** prepared for **individual organisational functions** and **consolidated into the Master Budget**.

Key sequence: **Sales → Production → Materials, Labour and Overheads → Master Budget**.

Main purpose: Coordination of departmental activities, resource planning and cost control.

Key principle: Functional budgets are **interdependent**; the output or estimates of one budget provide inputs for others.

Principal Budget Factor: The limiting factor governing operations. **Sales** is commonly the starting point, but material availability, labour or production capacity may be the constraint.

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Functional Budgets (cont)

Key distinction: Functional Budgets = Individual departmental plans; **Master Budget** = Consolidated organisational plan.

Main types:
1. **Sales Budget** → Expected sales quantity and revenue.
2. **Production Budget** → Units to be manufactured.
3. **Material Budget** → Materials required and purchases.
4. **Labour Budget** → Labour hours and labour cost.
5. **Overhead Budget** → Indirect production expenses.

Sales Budget

Core concept: **Estimates expected sales quantity** and revenue for a specified period.

Main focus: How much can the organisation sell, and at what price?

Formula: **Sales Revenue = Budgeted Units × Selling Price per Unit**.

Methods: Market research, sales force composite, trend analysis, statistical methods, expert opinion and test marketing.

Major strength: Provides the basis for production and other functional budgets.

Major limitation: Accuracy depends on demand forecasts and market conditions.

Production Budget

Core concept: **Estimates units to be manufactured** to meet expected sales and desired inventory.

Main focus: How much should the organisation produce?

Formula: **Production = Sales + Desired Closing Stock − Opening Stock**.

Key inputs: Sales forecast, opening inventory, desired closing inventory and production capacity.

Major strength: Coordinates production, sales, inventory and resource requirements.

Production Budget (cont)

Major weakness: Depends on accurate sales forecasts and availability of production resources.

Key distinction: Sales Budget = Units expected to be sold; Production Budget = Units required to be manufactured.

Numerical trap: **Higher closing stock increases production; higher opening stock reduces production**.

Material Budget

Core concept: Estimates raw material quantity and cost required for production and the purchases needed to maintain desired inventory.

Types: **Material Consumption Budget** and **Material Purchase Budget**.

Main focus: How much material will be consumed, and how much must be purchased?

Key inputs: Production, material consumption per unit, opening stock, desired closing stock and purchase price.

Major strength: Ensures material availability and supports purchase planning and cost control.

Major weakness: Depends on accurate production estimates, consumption standards and supply availability.

Key distinction: **Consumption** = Material needed for production; **Purchases** = Consumption **adjusted for inventory**.

Numerical trap: If wastage is expressed as a percentage of input, **Required Input = Good Output ÷ (1 − Wastage Rate)**.

Formulas:
- **Material Required** = Production Units × Material per Unit.
- **Material Purchases** = Material Required + Desired Closing Stock − Opening Stock.
- **Purchase Cost** = Purchase Quantity × Purchase Price.

Labour Budget

Core concept: Estimates **labour hours, workforce requirements and labour cost** for **planned production**.

Main focus: How many workers and labour hours are required, and what will they cost?

Key inputs: Production, labour time standards, wage rates, workforce availability and productivity.

Major strength: Helps plan workforce requirements and control labour costs.

Major weakness: Productivity, absenteeism, labour turnover and overtime can make estimates inaccurate.

Key distinction: Labour Hours Budget = Time required; Labour Cost Budget = Wages required.

Keyword associations: **Idle Time** → Paid but unproductive time; **Overtime** → Work beyond normal hours; **Labour Turnover** → Employees leaving and being replaced.

Formulas:
- **Labour Hours** = Production Units × Labour Hours per Unit.
- **Labour Cost** = Labour Hours × Wage Rate.
- **Workers Required** = Total Labour Hours ÷ Working Hours per Worker.
- **Labour Productivity** = Output ÷ Labour Hours.

Overhead Budget

Core concept: Estimates **indirect expenses** expected to be incurred during a specified period.

Functional classification: Production / Factory → Administration → Selling → Distribution.

Cost behaviour: Fixed → Variable → Semi-variable.

Key process: Identify overheads → Classify by function → Classify by behaviour → Estimate → Consolidate → Monitor.

Formula: **OAR = Budgeted Overheads ÷ Budgeted Activity**.

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Overhead Budget (cont)

Allocation: Charging an overhead directly to **one cost centre**.

Apportionment: Distributing common overhead among **multiple cost centres**.

Major strength: Helps control indirect costs and estimate total production expenditure.

Major weakness: Estimation and allocation of indirect costs can involve judgement.

Keyword associations:
- Factory rent → Production overhead.
- Advertising → Selling overhead.
- Delivery → Distribution overhead.
- Office rent → Administration overhead.
- Machine hours → Common overhead absorption base.

Cash Budget

Core concept: Estimates **future cash receipts and payments** to determine **cash surplus** or **deficit**.

Main focus: When will cash actually come in and go out?

Formula: **Closing Cash = Opening Cash + Cash Receipts − Cash Payments**.

Methods: **Receipts and Payments Method; Adjusted Profit and Loss Method; Balance Sheet Method**.

Cash receipts: Cash sales, debtor collections, loans received, sale of assets and other cash inflows.

Cash payments: Supplier payments, wages, overheads, taxes, capital expenditure, loan repayments and interest.

Non-cash items: Depreciation, provisions and bad debts are excluded as cash movements.

Major strength: Helps manage liquidity and anticipate financing requirements.

Major weakness: Depends on accurate forecasts of receipts, payments and their timing.

Cash Budget (cont)

Key distinction: Cash Budget = Future cash forecast; Cash Flow Statement = Actual historical cash flows.

Cash Budget Methods
- **Receipts & Payments**: Opening cash + cash receipts − cash payments.
- **Adjusted P&L**: Start with estimated profit; add non-cash expenses, adjust working capital changes and other cash items.
- **Balance Sheet**: Prepare estimated closing balance sheet; cash/bank is the balancing figure.

Closing Cash = Total Liabilities + Capital - Other Assets

Note:
- Profit does not necessarily mean positive cash flow.

Receipts and Payments Method

Concept: Prepare a period-wise statement of all expected cash receipts and cash payments.

1. **Cash receipts — ADD (+)**

Item Treatment
> Cash sales Add
> Collection from debtors Add
> Sale of fixed assets Add
> New loan received Add
> Issue of shares/debentures Add
> Interest/dividend received Add
> Other cash income Add
> Opening cash/bank balance Add

2. **Cash payments — SUBTRACT (−)**

Item Treatment
> Cash purchases Subtract
> Payment to creditors Subtract
> Wages and salaries Subtract
> Rent and other expenses paid Subtract
> Purchase of fixed assets Subtract
> Loan principal repaid Subtract
> Interest paid Subtract
> Tax paid Subtract

Receipts and Payments Method (cont)

> Dividend paid Subtract
> Other cash expenses Subtract

3. Important adjustments in numerical questions

A. Credit sales and debtor collections

If sales are on credit, don't include the entire sales amount as cash received. Calculate collections based on the given credit terms.

Example:
- January credit sales = ₹1,00,000
- 60% collected in January
- 40% collected in February

January receipt = ₹60,000; February receipt = ₹40,000.

B. Credit purchases and creditor payments

Similarly, purchases are not cash payments until suppliers are paid.

Example:
- January credit purchases = ₹80,000
- 70% paid in January
- 30% paid in February

January payment = ₹56,000; February payment = ₹24,000.

C. Outstanding and prepaid expenses
- Outstanding expense: Include when actually paid.
- Prepaid expense: Include when cash is paid, even if it relates to a future period.

D. Non-cash items

Exclude:
- Depreciation
- Amortisation
- Goodwill written off
- Provision for doubtful debts
- Credit purchases/sales not yet settled in cash

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Adjusted Profit and Loss Method

The objective is to convert accounting profit into estimated cash.

Step 1. **Start with Net Profit**

Take the estimated net profit as given in the question.

Step 2. **Adjust non-cash and non-operating items**

Item Treatment Shortcut

> Depreciation: Add (+) Expense, but no cash paid

> Amortisation: Add (+) Non-cash expense

> Provision for doubtful debts: Add (+) No immediate cash outflow

> Goodwill written off: Add (+) Non-cash expense

> Loss on sale of fixed asset: Add (+) Accounting loss, not operating cash

> Profit on sale of fixed asset: Subtract (−) Accounting gain, not operating cash

> Interest income credited to P&L: Subtract (−) Remove if separately treated as cash inflow

> Dividend income credited to P&L: Subtract (−) Remove if separately treated as cash inflow

Shortcut: Non-cash expenses → ADD. Non-cash gains → SUBTRACT.

Step 3. **Adjust working capital changes**

This is where MCQs can test whether you understand the direction of adjustment.

Working capital item Increase Decrease

> Debtors / Receivables − +

> Stock / Inventory − +

> Prepaid expenses − +

> Creditors / Payables + −

> Outstanding expenses + −

> Income received in advance + −

> Accrued income − +

Two powerful shortcuts:

Adjusted Profit and Loss Method (cont)

- **Current assets: Increase → subtract; decrease → add.**
- **Current liabilities: Increase → add; decrease → subtract.**

Why? More current assets generally tie up cash; more current liabilities generally preserve cash by delaying payment.

Step 4. **Account for other cash items separately**

Once you have calculated cash generated from operations, account for other cash flows.

Transaction Treatment Reason

> Purchase of machinery / building − Cash paid

> Sale of machinery / building + Cash received

> Purchase of investments − Cash paid

> Sale of investments + Cash received

> New loan raised + Cash received

> Loan principal repaid − Cash paid

>Issue of shares + Cash received

> Redemption / buyback of shares − Cash paid

> Interest paid − Cash outflow

> Tax paid − Cash outflow

> Dividend paid − Cash outflow

> Opening cash balance + Already available cash

Shortcut:

- **Money coming IN → ADD.**
- **Money going OUT → SUBTRACT.**
- **Ignore non-cash transactions.**

Step 5. Calculate closing cash

Closing Cash=Opening Cash+Net Cash Movement

Master Budget

Core concept: **Consolidated overall budget** combining functional budgets.

Operating Budget: Sales, production, material, labour, overheads and budgeted P&L.

Master Budget (cont)

Financial Budget: Cash budget, capital expenditure, financing and budgeted balance sheet.

Key process: **Functional budgets → Operating and financial plans → Master Budget**.

Major purpose: Coordination, resource allocation, planning and control.

Key distinction: Functional = individual department; Master = organisation-wide.

Keyword association: Master Budget = Integrated plan; **Pro forma = Budgeted financial statements**.

Budgeted Income Statement and Balance Sheet

Budgeted Income Statement: Forecasts revenue, expenses and profit.

Format: **Sales − COGS = Gross Profit − Operating Expenses = EBIT − Interest − Tax = PAT**.

COGS: Opening Stock + Purchases + Direct Expenses − Closing Stock.

Budgeted Balance Sheet: Forecasts assets, liabilities and equity.

Key calculations: **Debtors** = Opening + Credit Sales − Collections − Bad Debts; **Creditors** = Opening + Credit Purchases − Payments.

Fixed assets: Opening net assets + Purchases − Book Value Sold − Depreciation.

Key equation: **Assets = Liabilities + Equity**.

Connection: **PAT retained increases reserves/retained earnings**.

Key distinction: **Income Statement = performance over a period; Balance Sheet = financial position on a date**.

A. Format of Budgeted Income Statement

Sales Revenue

Less: Cost of Goods Sold

Gross Profit

Less: Operating Expenses

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Budgeted Income Statement and Balance Sheet (cont)

Selling expenses
Administrative expenses
Operating Profit (EBIT)
Add: Non-operating income
Less: Finance cost / Interest
Profit Before Tax (PBT)
Less: Tax
Profit After Tax (PAT)
B. Format of Budgeted Balance Sheet
Liabilities and Equity
Share capital
Reserves and surplus
Long-term borrowings
Trade payables / Creditors
Outstanding expenses
Other liabilities
Total
Assets
Fixed assets
Less: Accumulated depreciation
Inventory / Closing stock
Trade receivables / Debtors
Cash and bank
Prepaid expenses
Total
The fundamental accounting equation: **Assets = Liabilities + Equity**.

Types and Modern Approaches to Budgeting

Zero-based budgeting.

Associated with: **Peter A. Pyhrr**.

Origin of the modern approach: Developed and popularised at **Texas Instruments**.

Starting point: **Zero base**.

Zero-based budgeting. (cont)

Core requirement: Fresh justification of expenditure.

Key terminology: **Decision unit, decision package, ranking**.

Resource allocation: Based on evaluated priorities and available resources.

Application: Both existing and new activities can be evaluated.

Major weakness: Time-consuming and costly preparation.

Major strength: Identification and elimination of unnecessary expenditure.

ZBB in six words/steps
Zero → Identify → Justify → Evaluate → Rank → Allocate
Start afresh → identify activities → prepare packages → evaluate proposals → rank priorities → distribute funds.

- **Decision unit** = where expenditure is examined.
- **Decision package** = why the activity deserves funding.
- **Ranking** = which package gets priority.

Performance Budgeting

Core concept: Links financial allocations with physical performance and results.

Main focus: What was achieved with the money spent.

Key components: **Inputs (resources), Outputs (goods/services delivered), Outcomes (broader results)**.

Three Es: **Economy (cost of resources), Efficiency (input-output relationship), Effectiveness (achievement of objectives)**.

Major strength: Better accountability and result-oriented resource allocation.

Major weakness: Difficult to measure outcomes; requires reliable data and monitoring.

Performance Budgeting (cont)

India: First ARC recommended it in 1966; introduced in selected ministries in 1968–69.

Outcome Budget: Introduced in 2005–06; focuses on measurable outcomes and impact.

Performance Budgeting in six steps
Objectives → Activities → Targets → Resource allocation → Performance measurement → Review.

- **Input** = resources used.
- **Output** = direct goods/services delivered.
- **Outcome** = broader result achieved.
- Performance vs Outcome Budget = work and performance vs results and impact.

Programme Budgeting

Core concept: Organises and allocates expenditure around programmes and organisational objectives.

Main focus: What programmes should be undertaken to achieve desired objectives.

Key structure: **Programme → Sub-programme → Activity**.

Resource allocation: Based on programme objectives, priorities and requirements.

Major strength: Better coordination, planning and objective-oriented allocation.

Major weakness: Complex classification, overlapping activities and coordination difficulties.

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Programme Budgeting (cont)

PPBS → **Planning–Programming–Budgeting System**. Connection: Programme Budgeting is one important element within the broader PPBS approach. **Robert McNamara** → Associated with the introduction/popularisation of PPBS in the US Department of Defense in the 1960s.

Programme Budgeting in six steps **Objectives → Programmes → Sub-programmes → Activities → Resource allocation → Review**.

- **Programme** = broad objective-oriented grouping of activities.
- **Sub-programme** = component of a programme.
- **Activity** = specific task undertaken.

Incremental Budgeting

Core concept: Uses the previous period's budget as the base and adjusts it for expected changes.

Main focus: What changes are required to the existing budget?

Key process: **Previous Budget → Adjustments (+/−) → Revised Budget → Approval → Control**

Formula: **New Budget = Previous Budget + Net Adjustments**.

Adjustments: May include **both increases and reductions**.

Major strength: Simple, economical, less time-consuming and predictable.

Major weakness: Perpetuates historical inefficiencies; limited scrutiny of existing expenditure.

Budgetary slack: Deliberate overestimation of costs or underestimation of revenues.

Numerical trap: Consecutive percentage increases are **compounded**.

Suitability: Relatively **stable operating environments**.

Keyword association: **Use-it-or-lose-it** → Incremental Budgeting.

Rolling / Continuous Budgeting

Core concept: A budget that is **continuously updated** by adding a new future period as the current period ends.

Main focus: Maintaining a continuously updated, fixed future planning horizon.

Key process: **Set Planning Horizon → Prepare Budget → Monitor Actuals → Revise Estimates → Drop Completed Period → Add New Period**.

Example: A 12-month budget is continuously rolled forward by dropping the completed month and adding a new month.

Frequency: **Monthly, quarterly or other periodic intervals**.

Major strength: Continuous planning, adaptability and improved forecasting.

Major weakness: Time-consuming, costly and administratively demanding.

Suitability: **Dynamic and uncertain business environments**.

Key distinction: Rolling Budget = Updates the time horizon; Flexible Budget = Adjusts for activity levels.

Keyword association: **Fixed planning horizon + continuous updating** → Rolling Budgeting.

Activity-Based Budgeting (ABB)

Core concept: Estimates budget requirements based on expected activities and the resources needed to perform them.

Main focus: What activities are required, in what quantity, and what resources will they consume?

Key process: **Forecast Demand → Identify Activities → Estimate Activity Quantities → Identify Cost Drivers → Estimate Resources → Prepare Budget → Monitor**.

Activity-Based Budgeting (ABB) (cont)

Cost driver: Factor that causes or influences the cost of an activity.

Activity cost pool: Collection of costs associated with a particular activity.

Major strength: Better cost estimation, resource allocation and identification of inefficient activities.

Major weakness: Complex, time-consuming, costly and data-intensive.

Suitability: Organisations with **diverse activities** and **significant overhead costs**.

Key distinction: ABC calculates product/service costs using activities; ABB estimates future resource requirements using expected activities.

Keyword association: **Cost drivers + Expected activities → Activity-Based Budgeting**

Participative Budgeting

Core concept: Budget prepared with the involvement of managers and employees at different organisational levels.

Main focus: Who participates in budget preparation?

Alternative name: **Bottom-Up Budgeting**.

Key process: **Top Management Guidelines → Departmental Estimates → Discussion & Negotiation → Consolidation → Approval → Implementation**.

Major strength: Better estimates, motivation, ownership, commitment and coordination.

Major weakness: Time-consuming; risk of budgetary slack and departmental conflicts.

Budgetary slack: Deliberate overestimation of costs or underestimation of revenues.

Key distinction: Participative budgeting focuses on involvement in preparation; Responsibility Budgeting focuses on accountability.

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Participative Budgeting (cont)

Keyword association: Bottom-up approach → Participative Budgeting.

Responsibility Budgeting

Core concept: Budgets are prepared for different **responsibility centres**, and managers are held **accountable** for their respective performance.

Main focus: Who is responsible for costs, revenue, profit and investment?

Key structure: **Cost Centre → Revenue Centre → Profit Centre → Investment Centre**.

Performance measures: **Cost Centre** → Cost control. **Revenue Centre** → Revenue generation. **Profit Centre** → Profit (Revenue and costs). **Investment Centre** → ROI / Residual Income (Revenue, costs and assets/investment).

Key principle: **Controllability Principle** — managers should be evaluated primarily on factors within their control.

Major strength: Clear accountability, cost control, performance evaluation and decentralisation.

Major weakness: Departmental conflicts, uncontrollable factors and difficulty allocating common costs.

Key distinction: Responsibility Budgeting focuses on **accountability**; Participative Budgeting focuses on employee involvement in budget preparation.

Keyword association: Responsibility Centres → Responsibility Budgeting.

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