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Management Accounting

Unit 4

Q: What is a budget? What are the characteristics of a budget?

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Ans:

A budget is the monetary or/ and quantitative expression of business plans and policies to be pursued in the future period of time. It is a blue print of a plan expressed in quantitative terms.

According to CIMA, London, "A budget is a financial and/ or quantitative statement prepared prior to a defined period of time, of the policy to be pursued during that period for the purpose of attaining a given objective."

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CHARACTERISTICS OF A BUDGET:

1) *A budget is concerned for a definite future period.*
2) *A budget is a written document*
3) *A budget is a detailed plan of all the economic activities of a business.*
4) *A Budget is prepared for the attainment of pre-determined objectives.*
5) *All the departments of a business unit co-operate for the preparation of a business budget.*
6) *Usually a budget is prepared in monetary units but budgets for some departments are also prepared in physical units like the budget of production department, stores department and sale department.*
7) *Budget works as a standard and all departmental plans are implemented and evaluated on the basis of a budget.*
8) *A budget is an instrument of achieving business objectives and it is not an end itself.*
9) *Every year a budget is prepared and throughout the year it is implemented, corrected and controlled, therefore, it is a continuous process.*
10) *Budget helps management in planning, co-ordination and control. Thus, Budget is an effective instrument for management. It also helps to check and evaluate the performance of each department.*
11) ***Prepared in Advance**: It is prepared in advance and is derived from the long-term strategy of the organization.*
12) ***Related to Future**: It is related to future period for which objectives or goals have already been laid down.*
13) ***Expressed in Quantitative / Financial Terms**: It is expressed in quantitative form, physical or monetary units, or both.*

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Q: What is budgetary control? What are its objectives? What are the advantages and limitations of budgetary control?

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Ans:

Budgetary control is a technique of control with the use of budgets. It is the process of determining various budgeted figures for the enterprises for the future period and then comparing the budgeted figures with the actual performance for calculating variances, if any. The comparison of budgeted and actual figures will enable the management to find out discrepancies and take remedial measures at a proper time.

According to **C.I.M.A.,** London, "Budgetary control is the establishment of budgets relating to the responsibilities of executives to the requirements of a policy and the continuous comparison of actual with budgeted results either to secure by individual action the objective of that policy or to provide a basis for revision."

Wheldon characterizes budgetary control as 'planning in advance of the various functions of a business so that the business as a whole is controlled."

J. Batty defines it as "A system which uses budgets as a means of planning and controlling all aspects of producing and/ or selling commodities and services."

According to **Welsch**, "Budgetary control involves the use of budget and budgetary reports, throughout the period to co-ordinate, evaluate and control day-to-day operations in accordance with the goals specified by the budget".

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OBJECTIVES OF BUDGETARY CONTROL:

The main objectives of budgetary control are as follows:

1) To achieve firm's objectives effectively and efficiently.

2) To determine targets of performance for each section or department of the business for the budget period.

3) To co-ordinate the various activities of the business.

4) To provide a basis for the comparison of actual performance with the predetermined targets.

5) To ascertain the variance (i.e., differences between actual performance and budgeted performance) and analyse the reasons for the same.

6) To ensure planning for future by setting up various budgets. The requirements and expected performance of the enterprise are anticipated.

7) To operate various cost centres and departments with efficiency and economy.

8) To ensure the best use of all available resources to maximise profit or production subject to the budget (or limiting) factors.

9) To Eliminate of wastes and increase in profitability.

10) To anticipate capital expenditure for future

11) To centralise the control system

12) To decentralise responsibility to each manager.

13) To correct deviations from the established standards

14) To fix responsibility of various individuals in the organisation so that everyone knows what is expected of him and how he will be judged.

15) To portray with precision the overall aims of the business and determining the targets of performance for each section or department of the business.

16) To exercise control on cost through comparison of the actual performances with the budgeted figures.

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17) To take the necessary corrective measures, either on the budget side or on the performance side. The budget targets may have been fixed up too high to attain, and so require corrective measures on the budget side, or that the performance has been below the standard, and so it requires tightening up the production efficiency.
18) To optimal utilisation of physical and financial resources of the business.
19) To protect the business from future risks and uncertainties.
20) To establish co-ordination between various departments.

ADVANTAGES OF BUDGETARY CONTROL:

The budgetary control system helps in fixing the goals for the organisation as a whole and concerted efforts are made for its achievements. Some of the advantages of budgetary control are:

1) Maximisation of Profits:

The budgetary control aims at the maximisation of profits through effective cost control and the proper utilisation of the resources and existing facilities of the business. To achieve this aim, a proper planning and co-ordination of different functions is undertake.

2) Proper co-ordination

The working of different departments and sectors is properly coordinated. The budgets of different departments have a bearing on one another. The co-ordination of various executives and subordinates is necessary for achieving budgeted targets.

3) Provides Specific Aims:

The efforts are directed towards achieving some specific aims. Every department is given a target to be achieved. If there is no definite aim then the efforts will be wasted in pursuing different aims.

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4) Tool for Measuring Performance

By providing targets to various departments, budgetary control provides a tool for measuring managerial performance. The budgeted targets are compared to actual results and deviations are determined. The performance of each department is reported to the top management.

5) Economy

The finance is put to optimum use. The resources are used economically, wastages are eliminated and overheads are controlled. This brings about an economy in expenditure.

6) Corrective Action

The management will be able to take corrective measures whenever there is a discrepancy in performance. The deviations will be regularly and timely reported so that necessary action is taken at the earliest.

7) Creates Budget Consciousness

It creates budget consciousness among the employees. By fixing targets for the employees, they are made conscious of their responsibility. Everybody knows what he is expected to do and he continues with his work uninterrupted.

8) Determines Weaknesses

The deviations in budgeted and actual performance will enable the determination of weak sports. Efforts are concentrated on those aspects where performance is less than the stipulated.

9) Introduction of Incentive Schemes

Budgetary control system also enables the introduction of incentive schemes of remuneration. The comparison of budgeted and actual performance will enable the use of such schemes.

10) Effective Utilisation of Resources :

It ensures *effective utilisation of men, materials, machines and money* because production is planned according to the availability of these items.

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11) Fixes Responsibility:

Everyone working in the concern knows what exactly to do. Budgetary ensures that individual responsibilities are clearly defined and that the required authority commensurate with the responsibility is delegated so that buck passing may be prevented when the budgeted results are not achieved.

12) Ensures Team Work:

Budgetary control takes the help of different levels of management in the preparation of the budget. Budget finally approved represents the judgement of the entire organisation and not merely that of an individual or a group of individuals. Thus, it ensures team work.

13) Facilitates Management by Exception:

Management by exception is possible because the comparison of actual and budgeted results points out weak spots. Management is required to pay their attention to the weak points only so that remedial action is taken against weak spots which are not in conformity with the budgeted performance.

14) Provides Measure of Efficiency:

Budget acts as a measure of efficiency of departments and persons working in the organisation because budgets provide a yardstick against which actual performance of departments and employees can be compared.

15) Enhances creditworthiness:

An effective budgetary control system enhances the standing and credit of the undertaking with the government and the banks because an efficient technique of cost control is used.

16) Removes Uncertainties among Lower Levels of Management:

The use of budgets removes clouds of uncertainties for lower levels of management regarding basic policies and objectives.

(Some of these points may also be included in the objectives of budgetary control)

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LIMITATIONS OF BUDGETARY CONTROL:

Despite many good points of budgetary control there are some limitations of this system. Some of the limitations are discussed below:

1) Uncertain Future:

The budgets are prepared for the future period.. The future is always uncertain and the situation which is presumed to prevail in future may change. The change in future conditions upsets the budgets which have to be prepared on the basis of certain assumptions. The future uncertainties reduce the utility of budgetary control system.

2) Revision Required:

Budgets are prepared on the assumptions that certain conditions will prevail. However, in rapidly changing conditions it may not be possible to achieve the budgeted targets. Budgets may have to be revised from time to time. The frequent revision of targets will reduce the value of budgets and revisions involve huge expenditures too.

3) Discourages Efficient Persons:

Under budgetary control system the targets are given to every person in the organisation. There may be some efficient persons who can exceed the targets but they will also feel contented by reaching the targets. So budgets serve as constraints on managerial initiatives.

4) Problem of Co-ordination:

The success of budgetary control depends upon the co-ordination among different departments. The performance of one department affects the results of other departments. To overcome the problem of co-ordination a Budgetary Officer is needed. Every concern cannot afford to appoint a Budgetary Officer. The lack of co-ordination among different departments results in poor performance.

5) Conflict among Different Departments:

Budgetary control may lead to conflicts among functional departments. Every departmental head worries for his department goals without thinking of business goal. Every department tries to get maximum allocations of fund and this raises a conflict among different departments.

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6) Depends upon Support of Top Management:
Budgetary control system depends upon the support of top management. The management should be enthusiastic for the success of this system and should give full support for it. If at any time there is a lack of support from top management then this system will collapse.

7) Not Affordable for Small Organisations:
Installation of budgetary control system is expensive; so small organisations cannot afford the employment of budgetary control as a cost control technique.

8) Not a substitute of management:
Budget is only a tool of the management and is not a substitute of management.

9) May Lead to Restricted Use of Resources:
The use-of –budget may lead to restricted use of resources. Budgets are often taken as limits. Efforts may, therefore, not be made to exceed the performance beyond the budgeted targets, even though it may be physically possible.

10) Based on Estimates: Budgets may or may not be true, as they are based on estimates.

11) Rigidity: Budgets are considered as rigid documents.

12) No Automatic Execution: Budgets cannot be executed automatically.

13) Lack of Staff co-operation: Staff co-operation is usually not available during budgetary control exercise.

14) Expensive: Its implementation is quite expensive.

Q: What are the preliminaries/ steps for the adoption of a system of Budgetary Control? *(www.prepnext.com)*

Ans:
Following are the pre-requisites or steps for the successful implementation of a sound system of budgetary control:

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1) Preparation of Organisation Chart:
A concern must have an organisation chart. This is necessary in order to have a clear idea of authority and responsibility of each executive so that there may be no conflict among functional executives for shirking responsibilities and blaming others for poor performance.

2) Clarifying objectives:
The budgets are used to realise objectives of the business. The objectives must be clearly spelt out so that budgets are properly prepared. In the absence of clear goals, the budgets will also be unrealistic. The scope of budgetary control should also be clearly laid down.

3) Fixation of Budgeted Output: The budgeted output should be stated in clear terms.

4) Identification of Budget Factor (or Key Factor or Limiting Factor):
The budget or key factor, if any, must be indicated before starting the preparation of budgets. The factor which sets a limit to the total activity is known as budget factor, key factor or limiting factor. For example, if production can not be increased inspite of heavy demand, due to non-availability of raw-material/ power, raw material/ power is called here key factor. The key factors should be correctly identified and their extent of influence must first be carefully assessed.

5) Establishment of Efficient System of Accounting:
There must be efficient system of accounting in order to record and provide necessary accounting information to the management for successful system of budgetary control.

6) Appointment of Budget Controller:
Although the Chief Executive is finally responsible for the budget programme, it is better if a large part of the supervisory responsibility is delegated to a special official designated as Budget Controller or Budget Director. Such a person should have knowledge of the technical details of the business and should report directly to the President or the Chief Executive of the organization.

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7) Formulation of Budget Committee:
Budget committee should be set up for the establishment and efficient execution of the plan. The Budget Controller is assisted in his work by the Budget Committee. The Committee consists of all the Heads of various departments, viz., Production, Sales, Finance, Personnel, Purchase, etc. with the Managing Director (or General Manager or or any other chief executive) as its Chairman. It is generally the responsibility of the Budget Committee to submit, discuss and finally approve the budget figures. Each member will prepare his own budget which will be discussed at the committee meeting before a final shape is given for co-ordinated action.

8) Proper Communication System:
To make budgetary control successful, there should be a proper system of communication and reporting between the various levels of management. A two way system of communication should be adopted. The top management should be able to communicate the budgeted plan to the lower levels in clear terms who in turn should feedback by reporting the deviations from the targets to the higher levels. On the basis of feedback, the top management may again communicate instructions to the lower management for taking corrective action.

9) Establishment of Budget Centres: Budget centres should be established for cost control and all budgets should be related to cost centres. Budget centres will disclose the sections of the organization where planned performance is not achieved.

10) Preparation of Budget Manual: There should be a budget manual to indicate charter of programme. It contains all details regarding the plan and procedures for its execution. It should also specify **the length of the budget period.** The length of the budget period depends upon the nature of the plan and circumstances of the business. For example, industries which are subject to fashion change use short budget period whereas industries involving long-term expenditure with relatively little change in product design use long budget periods.

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11) Precautions Needed:

(i) To motivate the workers, the budget must be prepared by those who are responsible for its performance.

(ii) The budget should cover all phases.

(iii) Top management approval is necessary in order to get full cooperation and acceptance of the system of budgetary control. The system may fail in future due to disagreements which may arise later on without approval of the top management.

(iv) The employees should be properly educated about the benefits of budgeting system. They should be educated about their role in the success of this system.

Contents of Budget manual :

Budget Manual should include the following matters:

(i) ***Introduction:*** *A brief explanation of the principle of budgetary control system, its objectives and benefits.*

(ii) *Procedure to be adopted in operating the system. For example, 'distribution instruction', will specify as to whom various budget schedules are to be sent.*

(iii) *Definition of duties and responsibilities of (a) operational executives. (b) budget committee and (c) budget controller.*

(iv) *Nature, type and specimen forms of various reports. It also specifies the persons responsible for the preparation of the reports and the programme of distribution of the reports to the various officers.*

(v) *The account code and classification used by the company.*

(vi) *The budget calendar showing the dates for completion of each part of the budget and submission of reports.*

(vii) *The budget periods and control periods.*

(viii) *The follow-up procedures.*

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Q: What is budgeting? What are the characteristics of good budgeting? *(www.prepnext.com)*

Ans:

MEANING OF BUDGETING:

Budgeting is the art of building budgets. Budgeting is a process of (i) making budgets and (ii) making use of budgets for further planning, co-ordinating and control purposes.

CHARACTERISTICS OF GOOD BUDGETING:

1) *A good budgeting system should involve persons at different levels while preparing the budgets. The subordinates should not feel any imposition on them.*
2) *There should be a proper fixation of authority and responsibility. The delegation of authority should be done in a proper way.*
3) *The targets of the budgets should be realistic. If the targets are difficult to be achieved then they will not motivate the persons concerned.*
4) *A good system of accounting is also essential to make the budgeting successful.*
5) *The budgeting system should have a whole-hearted support of the top management.*
6) *The employees should be imparted budgeting education. There should be meetings and discussions and the targets should be explained to the employees concerned.*
7) *A proper reporting system should be introduced. The actual results should be promptly reported so that performance appraisal is undertaken.*

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REQUIREMENTS OF A GOOD BUDGETING SYSTEM:

1) The organisational goal should be quantified and clearly stated. These goals should be within the framework of organisation's strategic and long-range plans.

2) Budgeting process should be backed and supported by the chief executive of an organisation.

3) The organisational goals must be divided in functional goals.

4) The budget should cover all phases of the organisation.

5) All persons in the organisation should mentally accept the exercise of budget preparation.

6) The persons responsible for execution of budget should participate in budget preparation.

7) The budget should be realistic. It should represent goals that are reasonably attainable.

8) The budgeting system should be based on information, communication and participation.

9) The budgeting should be a continuous exercise.

10) Periodic reports should be prepared promptly, comparing budget and actual results, i.e., there should be effective follow-up.

11) Clear cut organisational lines should be establishes with appropriate delegation of responsibilities for effective budget implementation.

Q: Explain briefly different types of budgets.

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Ans:

CLASSIFICATION OF BUDGETS:

The budgets are usually classified according to their nature. The following are the types of budgets which are commonly used:

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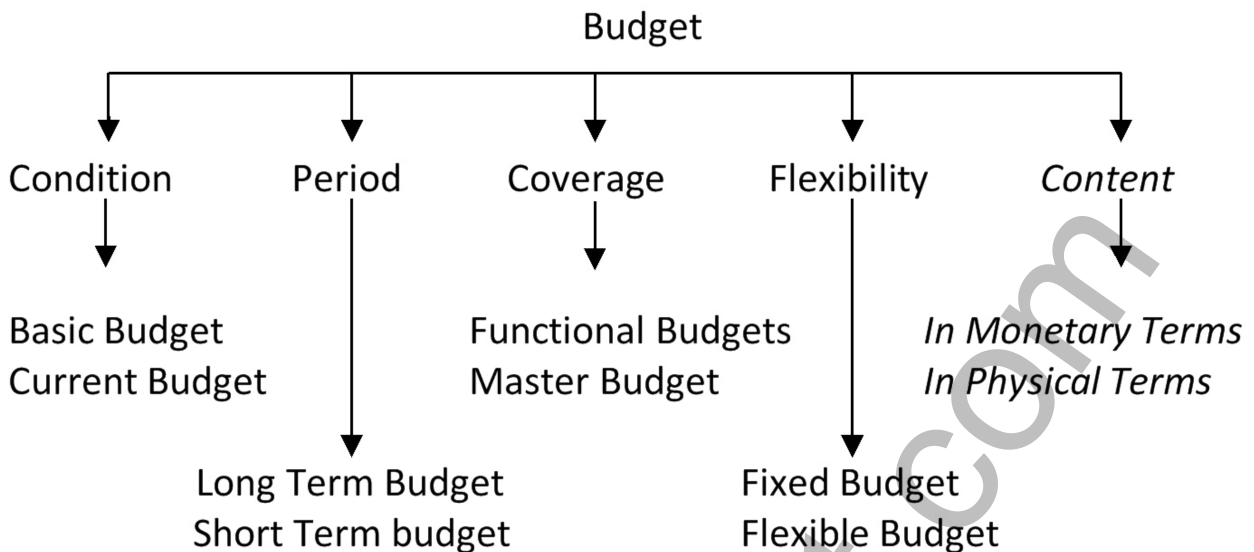

(A) Classification on the Basis of Condition

(i) Basic Budgets
(ii) Current Budgets

(B) Classification According to Period

(i) Long-term budgets
(ii) Short-term budgets

(C) Classification on the Basis of Coverage

(i) Functional Budgets
(ii) Master Budget

(D) Classification on the Basis of Flexibility *(NATURE/ CAPACITY)*

(i) Fixed budget
(ii) Flexible budget

(E) Classification on the Basis of Content

(i) In Monetary Terms
(ii) In Physical Terms

(A) Classification on the Basis of Condition

(i) Basic Budgets:

A basic budget has been defined as a budget which is prepared for use unaltered over a long period of time. This does not take into consideration current conditions and can be attainable under standard conditions.

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(ii) Current Budgets
A current budget can be defined as a budget which is related to the current conditions and is prepared for use over a short period of time. This budget is more useful than a basic budget, as the target it lays down will be corrected to current conditions.

(B) Classification According to Time

(i) Long –Term Budgets:
A long-term budget can be defined as a budget which is prepared for periods longer than a year. Such budgets help in business forecasting and forward planning. Capital Expenditure Budget and Research and Development Budget are examples of long-term budgets.

(ii) Short-term Budgets:
This budget is defined as a budget which is prepared for period less than a year. Short-term budgets are very useful to lower levels of management for control purposes. Cash budget and material budget are examples of short-term budgets.

(C) Classification on the Basis of Coverage

(i) Functional Budgets:
A functional budget is a budget which relates to any of the functions of an undertaking, e.g., sales, production, research and development, cash etc. Functional budgets are prepared for each function and they are subsidiary to the master budget of the business. Following functional budgets are generally prepared:

(a) Sales Budget:
The budget which shows the volume and value of sales of a business/ firm/ company during the budget period is known as Sales Budget.

Sales being the principal budget factor, sales budget is the most important budget and forms the basis on which all the

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other budgets are built up. This budget is a forecast of quantities and values of sales to be achieved in a budget period. The sales budget may be prepared according to products, sales territories, types of customers, salesmen etc. In the preparation of the sales budget, the sales manager should take into consideration various factors such as past sales figures and trends, salesmen's estimates, plant capacity, availability of raw materials and other supplies, general trade prospects, orders in hand, seasonal fluctuations, financial aspect, competition, potential market, general trade prospects, etc.

Sales Budget provides answers to the questions like:

(i) What is to be sold? (say Product X, Product Y)

(ii) When is it to be sold? (say 1st Quarter, 2nd Quarter)

(iii) Where is it to be sold? (say Northern Region, Southern Region)

(iv) By whom is it to be sold? (say Salesman P, Salesman Q)

Format of Sales Budget:

A simplest format of a Sales Budget is given below:

Sales Budget (in units & Rs.)

For the Budget period ending.........

Product / Period	Product 'A'			Product 'B'		
	Units	Rate Rs.	Amount Rs.	Units	Rate Rs.	Amount Rs.
1st Quarter	.....	.....	.....	.....	.....	.....
2nd Quarter	.....	.....	.....	.....	.....	.....
3rd Quarter	.....	.....	.....	.....	.....	.....
4th Quarter	.....	.....	.....	.....	.....	.....
	.....	.....	.....	.....	.....	.....

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(b) Production Budget:

This budget is prepared after the preparation of Sales Budget, to determine the quantity of goods which should be produced to meet the budgeted sales after keeping sufficient inventories. In production budget, the management decides, when and how many units of various products are to be prepared to fulfil the requirement of Sales Budget. Budgeted production is equal to projected sales plus closing inventory of finished goods minus opening stock of finished goods.

This budget is prepared after taking into consideration the estimated opening stock, the estimated sales and the desired closing finished stock of each product. Suppose, if the estimated opening stock of product X is 2,000 units, and the estimated sales is 15,000 units and the closing stock of the product is 2,500 units, the estimated production will be 15,000 + 2,500 – 2000 (Sales + Closing Stock – Opening Stock) = 15,500 units.

The following factors should be considered while preparing production budget:

(i) Sales requirements as per sales budget

(ii) Inventory Polices (such as stable minimum inventory policy or variable inventory policy)

(iii) Production Policy (such as stable production policy or variable production policy.

(iv) Availability of Plant Capacity

(v) Availability of inputs such as Raw- materials, labour.

(vi) Manufacturing cycle (i.e., the time gap between the purchase of raw-material and the production of finished goods).

(vii) Make or Buy Policy

(viii) Sub-contracting Policy.

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Format of Production Budget:

A simple format of a Production Budget is given below:

Production Budget (in Units)

For the Budget period ending.........

Particulars \ Product & Period	Product 'X'				Product 'Y'			
	I Qtr.	II Qtr.	III Qtr.	IV Qtr.	I Qtr.	II Qtr.	III Qtr.	IV Qtr.
A. Budgeted sales	.....	.....	.....	.....	.....	.....	.....	.....
B. Add: Budgeted Closing Stock of Finished Goods	.....	.....	.....	.....	.....	.....	.....	.....
C. Less: Budgeted Opening Stock of Finished Goods	.....	.....	.....	.....	.....	.....	.....	.....
D. Budgeted Production	.....	.....	.....	.....	.....	.....	.....	.....

(c) Production Cost Budget

Production cost budget expresses the cost of carrying out production plans and programmes set out in production budget. It generally represents the aggregate of direct material cost, direct labour cost, direct expenses and factory overheads. It summarises material cost, labour cost and factory overhead for production. In brief, this budget summarises direct material cost budget, direct labour cost budget and factory overheads budget.

Production Cost Budget represents the amount of total production cost to be incurred during the budget period. Production Cost Budget provides answers to the questions like:

(i) What amount is to be incurred on material cost?
(ii) What amount is to be incurred on labour cost?
(iii) What amount is to be incurred on production overheads?
(iv) When is it to be incurred? (say 1st Quarter, 2nd Quarter)

Format of Production Cost Budget:

A simple format of Production Cost Budget is given below:

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Production Cost Budget

For the Budget period ending.........

Period / Product	Product W	Product X	Product Y	Product Z	Total
1st Quarter					
Direct Material	.....	.....	.....	.....	.....
Direct Labour Cost	.....	.....	.....	.....	.....
Direct Expenses	.....	.....	.....	.....	.....
Prime Cost	.....	.....	.....	.....	.....
Production Overheads	.....	.....	.....	.....	.....
Production Cost	.....	.....	.....	.....	.....
2nd Quarter					

(d) Direct Material Purchase Budget:

This budget indicates, either in terms of money or of quantity, the expected purchases of raw materials to be made during the budget period. This budget is useful in planning the purchases and the finances required for purchase. Direct Material Purchase Budget is generally based on Production Budget. The following factors should be considered while preparing direct material purchase budget:

(i) Production requirements as per production budget.
(ii) Inventory Policies regarding stocks of each item of raw-material required.
(iii) Quality standards for each item of material
(iv) Standard requirement of each item of material required after considering normal loss in process.
(v) Standard Prices for each item of materials required
(vi) Economic Order Quantity
(vii) Re-order Level
(viii) Safety Stocks
(ix) Inefficiency (i.e. wasting allowance) in the use of material

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Format of Direct Material Purchase Budget:

A simple format of Direct Material Purchase Budget is given below:

Direct Material Purchase Budget (Quantity and Value)

Particulars	Material X	Material Y
A. Budgeted Usage (for Production):		
For Product 'A'	…..	…..
For product 'B'	…..	…..
Total	…..	…..
Add:…….% Inefficiency (if any)	…..	…..
Total Usage	…..	…..
B. Add: Closing Stock of Material	…..	…..
C. Less: Opening Stock of material	……	……
D. Budgeted Purchases (units) [A + B – C]	…..	…..
E. Rate per unit (Rs.)	…..	…..
F. Budgeted Purchases (Rs.) (D x E)	…..	…..

(e) Direct Labour Budget:

Direct labour budget gives an estimate of the requirements of direct labour essential to meet the production target. It ensures that the required number of various kinds of labour is available at the right time. There is no importance of other factors of production without labour because labour is an active factor while other factors are inactive or dormant. Direct labour budget provides answers to the questions like:

(i) What type of labour is required? (say skilled, semi-skilled, unskilled)
(ii) When is it required? (say 1st Quarter, 2nd Quarter)
(iii) Where is it required? (say Plant I, Plant II)

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(f) Direct Expenses Budget:

Direct Expenses Budget signifies the expenses to be incurred on budgeted production during the budget period. These expenses are directly related with production and change as per proportionate change in the output. Direct Expenses Budget includes all direct expenses except material and labour related with production. Direct expenses include carriage inward, octroi, power etc.

(g) Plant Utilisation Budget:

This budget lays down the requirements of plant capacity to carry out the production as per the production programme. This budget is expressed in terms of convenient physical units as weight or number of products or working hours.

(h) Manufacturing Expenses or Works Overhead Budget:

Manufacturing overheads Budget states the costs which are essential for manufacturing goods and indirectly related with production. Manufacturing expenses refers to the aggregate of factory overheads, like, indirect material, indirect labour and other indirect expenses. The budget may be classified into fixed cost, variable cost and semi-variable cost.

(i) Administrative Overheads Budget:

The Administrative Cost Budget signifies the expenses which are to be incurred on the operating activities of office during the plan period. It represents the amount of total office and administrative expenses to be incurred during the budget period. It includes all the expenses that are incurred to run the administration whether expenses are of fixed or variable nature. Examples of such costs are salaries of the office staff; rent/ depreciation of office building; depreciation, repairs, maintenance, insurance of office furniture; printing and stationary, postage, telephone, etc.

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Generally, administrative expenses in an institution will be incurred for the activities like:

(i) Formulation of business policies
(ii) Directing the organisation, and
(iii) Controlling the operations of an organisation, etc.

(j) Selling and Distribution Overheads Budget:
Selling and Distribution Cost Budget represents the amount of total selling and distribution cost to be incurred during the budget period. The Selling and Distribution overheads are based on sales forecasts because these are directly related with sales. The Selling and Distribution Expenses may include the following expenses:

(a) Direct Selling Expenses, e.g., Salaries, Commission, Expenses of Salesmen etc.
(b) Distribution Expenses, e.g., Rent, Rates, Wages, Insurance etc. of the warehouse.
(c) Cost of Sales Office Expenses, e.g., Salaries, Rent, Rates, Light, Heat etc. of the Sales Office
(d) Publicity Expenditure, e.g., Press, Window Display, Posters, Radios, Televisions etc.

(k) Cash Budget:
Cash budget gives an estimate of the anticipated receipts and payments of cash during the budget period. Hence, this budget is divided into two parts, one showing the estimated cash receipts on account of cash sales, credit collections and miscellaneous receipts and the other showing the estimated disbursement on account of cash purchases, amount payable to creditors, wages payable to workers, indirect expenses payable, income tax payable, dividend payable, budgeted capital expenditure etc.. In short, every factor which affects the receipts and payments of cash is taken into account in the preparation of this budget.

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(l) Capital Expenditure Budget

The capital expenditure budget gives an estimate of the amount of capital that may be needed for acquiring the fixed assets required for fulfilling production requirements as specified in the production budget. Separate budgets may be prepared for different items of fixed assets such as plant and equipment budget, building budget etc. This budget provides answers to the questions like:

(i) What type of fixed assets are to be acquired? (say land, building, plant and machinery, furniture)

(ii) When these assets are to be acquired? (say 1st Quarter, 2nd Quarter)

(iii) Where these assets are to be acquired (say Plant I, Office I)

This budget should be prepared after considering the following factors:

(i) Capital Development Plans;

(ii) Modernisation Plans;

(iii) Renovation Plans;

(iv) Expansion Plans;

(v) Replacement Plans;

(vi) Availability of Long-term Funds;

(vii) Expected Future Earnings;

(m) Research and Development Cost Budget:

This budget provides an estimate of the expenditure to be incurred during the budget period on research and development to search new methods and techniques of production, sales/ marketing.

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(ii) Master Budget

The master budget is a summary budget which incorporates all functional budgets in a capsule form and shows Budgeted Income Statement for the budget period and Budgeted Balance Sheet as at the end of the budget period. Master budget is prepared by the integration of separate functional budgets. This budget is used to co-ordinate the activities of various functional departments and also to help as a control device. It is a consolidated summary of the various functional budgets. It serves as the basis upon which budgeted P & L A/c and forecasted Balance Sheet are built up.

This budget is very useful to the top management because it is usually interested in the summarised meaningful information provided by this budget.

ADVANTAGES OF THE MASTER BUDGET are as follows:

(I) A summary of all functional budgets in capsule form is available in one report.

(II) The accuracy of all the functional budgets is checked because the summarised information of all functional budgets should agree with the information given in the master budget.

(III) It gives an overall estimated profit position of the organisation for the budget period.

(IV) Information relating to forecast balance sheet is available in the master budget.

(D) Classification on the Basis of Flexibility

(i) Fixed budget

The fixed budgets are prepared for a given level of activity. It is a budget which is designed to remain unchanged irrespective of the level of activity actually attained. Fixed budgets are suitable under static conditions. In case the level of activity usually attained is different from the level of activity for budgeting purpose, the fixed budget becomes ineffective.

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(ii) Flexible budgets:
A flexible budget consists of a series of budgets for different level of activity. It, therefore, varies with the level of activity attained. It is defined as a budget which by recognizing the difference between fixed, semi-fixed and variable cost is designed to change in relation to the level of activity.

(E) Classification on the Basis of Content

(i) Budget in Monetary Terms:
Budgets may be expressed in monetary terms, i.e., in rupee terms, e.g., Cash Budget, Capital Expenditure Budget etc.

(ii) Budget in Physical Terms
Budget may also be expressed in physical terms, e.g., Material Budget, Production Budget, Sales Budget etc.

Q: Write a short note on Fixed Budget? *(www.prepnext.com)*

Ans:
The fixed budgets are prepared for a given level of activity. According to C.I.M.A London, " Fixed budget is a budget which is designed to remain unchanged irrespective of the level of activity actually attained". Fixed budgets are suitable under static conditions. This budget is drawn for one level of activity and one set of conditions. It is rigid budget and is drawn on the assumption that there will be no change in the budgeted level of activity. In case the level of activity usually attained is different from the level of activity for budgeting purpose, the fixed budget becomes ineffective. A master budget tailored to a single output level of (say) 20,000 units of sales is a typical example of a fixed budget.

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A Few Essential Conditions:

(i) When the nature of business is not seasonal
(ii) There is no impact of external factors on the business activities
(iii) The demand of the product is certain and stable.
(iv) Supply of production inputs is regular.
(v) There is a trend of price stability.

Generally, all above conditions are not found in practice. Hence, Fixed Budget is not significant in business concerns.

FEATURES:

The main features of a fixed budget are as follows:

(1) It is prepared for one fixed level of activity.
(2) It does not change with the change in the level of activity.
(3) Expenses are not classified into fixed, variable and semi-variable.

MERITS/ ADVANTAGES:

(i) Very simple to prepare
(ii) Less time consuming

DEMERITS/ DISADVANTAGES:

(i) It is misleading. A poor performance may remain undetected and a good performance may go unrealised.
(ii) It is not suitable for long period
(iii) It is also found unsuitable particularly when the conditions of the business are changing constantly.
(iv) It takes away the initiative from members of the administrative staff since they do not find any interest in their job.
(v) It is inadequate for control purposes.
(vi) Accurate estimates not possible

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Q: What is Flexible Budget? What are the advantages and disadvantages of a flexible budget? *(www.prepnext.com)*

Ans:

A flexible budget consists of a series of budgets for different level of activity. It, therefore, varies with the level of activity attained. A flexible budget is defined as a budget which by recognizing the difference between fixed, semi-fixed and variable cost is designed to change in relation to the level of activity.

The flexible budgets will be useful where level of activity changes from time to time. When the forecasting of demand is uncertain and the undertaking operates under conditions of shortage of materials, labour, etc., then this budget will be more suited.

Such a budget is prescribed in the following cases:

(a) Where the level of activity during the year varies from period to period, either due to the seasonal nature of the industry or to variation in demand. For example, in soft drinks industry.

(b) Where the business is a new one and it is difficult to foresee the demand.

(c) Where the undertaking is suffering from shortage of a factor of production such as materials, labour, plant capacity etc. The level of activity depends upon the availability of such a factor of production.

(d) Where an industry is influenced by changes in fashion.

(e) Where there are general changes in sales.

(f) Where the business units keep or introducing new products or make changes in the design of its products frequently.

(g) Where the industries are engaged in make to order business like ship-building.

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CHARACTERISTICS OF FLEXIBLE BUDGET:

(i) Adjustable according to Business Conditions
(ii) Prepared in advance for various levels of activity
(iii) It is a dynamic budget. It changes with the change in the level of activity.
(iv) Control possible over unfavourable impact of change in future
(v) Classification of cost in the form of Fixed, Semi-variable and Variable cost
(vi) Related to a particular period
(vii) Production possible at any level of activity.

ADVANTAGES/ MERITS/ IMPORTANCE of FLEXIBLE BUDGET:

(i) Easy Calculation:
With the help of Flexible Budget, the sales, costs and profit may be calculated easily by the business at various levels of production capacity.

(ii) Easy Adjustment of Change:
In flexible budget adjustment is very simple according to change in business conditions.

(iii) Knowledge about the impact of cost:
In flexible budget, the cost is classified into three categories, namely, fixed cost, semi-variable cost and variable cost and because of this it is very easy to know the real impact of cost factors on business profits.

(iv) Comparable:
With the help of flexible budget, the actual cost of production may be easily compared with budgeted cost in business and industry and right decisions may be taken by the management well in time.

(v) Cost Control:
After the completion of the budget period, the actual cost may be compared with budgeted cost and steps may be taken to minimise the variance. Hence, it helps the management in controlling cost.

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(vi) Determination of Production Level:
Flexible Budget shows budgeted cost with classification at various levels of activity along with sales and profits. Hence, the management can easily select the level of production which will give desired profits.

(vii) Suitable for business which is dynamic in nature:
More useful for business and industry whose nature is dynamic and seasonal and affected from the change in the income, habit, interest of the consumers and the business which is also affected from the changing government policy, demonstration of effect, business cycles and works under the conditions of perfect and monopolistic competition.

(viii) Helps in Assessing Performance:
It is helpful in assessing the performance of departmental heads because their performance can be judged in relation to the level of activity attained by the organisation.

(ix) Facilitates cost ascertainment
Cost ascertainment at different levels of activity is possible because a flexible budget is prepared for various levels of activity

LIMITATIONS OR DEMERITS OF FLEXIBLE BUDGET:

(i) The formulation of Flexible Budget is possible only when there is a proper accounting system maintained.
(ii) Flexible Budget also requires the system of standard costing in business.
(iii) The formulation of Flexible Budget depends upon availability of cost experts in the business.
(iv) The formulation of Flexible Budget is possible only when the perfect knowledge about the factors of production and variable business circumstances is available.
(v) It is very expensive and labour oriented.

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Q: Differentiate between Fixed Budget and Flexible Budget.

(www.prepnext.com)

Ans:

Basis	Fixed Budget	Flexible Budget
Assumption	It is based on the assumption that business conditions will remain constant.	It is based on the assumption that business conditions are changing.
Nature	It has a fixed nature. Change is not possible once prepared.	It has a dynamic/ variable nature. Adjustment is possible
Cost Classification	In Fixed budgets costs are not classified according to their nature i.e, fixed, variable and semi-variable.	Cost is classified into fixed, variable and semi-variable costs according to their nature
Comparison	Comparison of actual and budgeted performance cannot be done correctly if the volume of output differs.	The budgets are redrafted as per the changed volume and a comparison between budgeted and actual figures will be possible.
Business Decisions	Fixed Budget is less appropriate and suitable for business decisions	Flexible Budget is more appropriate and suitable for business decisions.
Effectiveness	Fixed Budget is less effective because it is not dynamic	Flexible Budget is more effective because it is dynamic.
Economy	Fixed Budget is less expensive and less time consuming.	Flexible Budget is more expensive and time consuming.
Fixation of prices and submission of tenders	If the budgeted and actual activity levels vary, the correct ascertainment of costs and fixation of prices becomes difficult. It creates difficulty in price-fixation and submission of tenders.	It helps in fixation of price and submission of tenders due to correct ascertainment of costs.

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Tool for cost control	It has a limited application and is ineffective as a tool for cost control.	It has more applications and can be used as a tool for effective cost control.
Number of Budget	Only one budget at a fixed level of activity is prepared due to an unrealistic expectation on the part of the management i.e., all conditions will remain unaltered.	Under it, series of budgets are prepared at different levels of activity
Cost Ascertainment	Under changed circumstances costs cannot be ascertained correctly.	The costs can be easily ascertained under different levels of activity.
Flexibility	A fixed budget remains the same irrespective of changed situations. It remains inflexible even if volume of business is changed.	A flexible budget is recast to suit the changed circumstances. Suitable adjustments are made if the situation so demands.

Q What is a cash budget? What are its advantages? How is it prepared? *(www.prepnext.com)*

Ans:
A cash budget is an estimate of cash receipts and disbursements during a future period of time. It represents the amount of estimated cash inflows, estimated cash outflows and deficit/ surplus over a given budget period.

Cash budget gives an estimate of the anticipated receipts and payments of cash during the budget period. Hence, this budget is divided into two parts, one showing the estimated cash receipts on

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account of cash sales, credit collections and miscellaneous receipts and the other showing the estimated disbursement on account of cash purchases, amount payable to creditors, wages payable to workers, indirect expenses payable, income tax payable, dividend payable, budgeted capital expenditure etc.. In short, every factor which affects the receipts and payments of cash is taken into account in the preparation of this budget, so that a consolidated cash position is determined

ADVANTAGES OF CASH BUDGET:

Following are the main advantages of preparing cash budget:

(i) It provides an opportunity to review the cash flow for future periods as realistically as possible and make sure that cash is available for revenue and capital expenditure.

(ii) It enables the management to determine the timings when there is likely to be a surplus/ shortage of cash.

(iii) It enables the management to determine the quantum of surplus/ shortage of cash.

(iv) where adequate amount of cash is not likely to be available during certain periods e.g. when payment of bonus, dividend, tax etc. fall due the company can know in advance so that advance action can be taken to make available the required amount on the most advantageous terms.

(v) If large surplus of cash is likely to result during certain periods, then it will be possible to plan most profitable investment of these funds.

(vi) It enables the management to prepare the borrowing schedule.

(vii) It enables the management to prepare the repayment schedule well in advance.

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(viii) It enables the management to plan for dividend payment well in advance.

(ix) It enables the management to plan for financing the expansion/ modernization of the existing plant.

(x) It enables the management to plan for financing a new project.

(xi) It enables the management to take advantage of cash discount.

(xii) Preparation of a cash budget by a company will help to plan its cash position in such a way that maximum seasonal discounts can be availed of.

(xiii) Even for obtaining funds from financial institutions, the system of preparing cash budgets helps to convince the bank or other financial institutions about the bonafides of the company's requirements.

(xiv) The importance of cash budget may be more in some trades than in others e.g. in trades where there are wide seasonal fluctuations or where long contracts are undertaken.

PREPARATION OF CASH BUDGET:

For the purpose of preparing cash budget, cash information is collected from other budgets such as sales budget, salary and wages budget, overhead budgets, material budget etc. In preparing cash budget, total budgeted cash inflows are added to the opening balance of cash and then the total budgeted cash outflows are deducted from there to know the closing balance of cash. If opening cash balance and estimated total cash receipts are much larger than the estimated payments, there will be surplus cash balance at close and management should take the necessary steps, to invest surplus funds for short period. On the other hand, if there is cash shortage, the management must plan the borrowings for short period to manage the deficiency.

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STEPS INVOLVED IN THE PREPARATION OF CASH BUDGET:

Step 1:

Ascertain the Opening Balance

Step 2:

Identify, Analyse and Estimate the Cash Inflows such as:

- *Cash sales*
- *collection from debtors and trading commission*
- *sale of investment,*
- *sale of fixed assets,*
- *interest and dividend on investments*
- *proceeds from issue of shares, debentures, etc.*

Step 3:

Identify, Analyse and Estimate the Cash Outflows such as:

- *cash purchases,*
- *payment to creditors,*
- *payment of operating expenses*
- *purchase of investments,*
- *purchase of fixed assets*
- *redemption of shares and debentures,*
- *payment of interest,*
- *tax and dividend, etc.*

Step 4:
Estimate the Net Cash Inflow and Outflow:
In case of deficit, necessary arrangement should be made to finance the deficit. In case of surplus, necessary arrangement should be made to invest the surplus.

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Specimen of Cash Budget:

Cash Budget
For the Budget period ending…….

Particulars	Period			
	Month 1 (Rs.)	Month 2 (Rs.)	Month 3 (Rs.)	Month 4 (Rs.)
(A) Opening Cash Balance	……	……	……	……
(B) Cash Receipts				
Cash Sales	……	……	……	……
Collections from Debtors	……	……	……	……
Proceeds from Issue of Shares/ Debentures	…..	…..	…..	…..
Proceeds from Sale of Fixed Assets	…..	…..	……	……
Misc. Non-operating Incomes received	…..	……	……	……
Total Receipts (B)	……	……	……	……
Total Cash Available (A + B)	…..	……	……	……
(C) Cash Payments:				
Cash Purchases of Material	……	……	……	……
Payments to Suppliers of Materials	……	……	……	……
Payments of Direct Labour Wages	……	……	……	……
Payment of Production Overheads (Excluding Non-Cash Costs like Depreciation)	…..	…..	…..	…..
Payment of Administration Expenses (Excluding Non-Cash Costs like Depreciation)	……	……	……	……
Payment of Selling and Distribution Expenses (Excluding Non-Cash Costs like Depreciation)	…..	…..	…..	…..
Redemption of Redeemable Pref. Shares/ Debentures/ Buy Back of Shares	…..	…..	…..	…..
Purchase of Fixed Asset	…..	…..	…..	……
Misc. Non-operating Expenses paid	…..	……	……	……
Advance Payment of Income-tax	…..	…..	…..	……
Payment of Dividend (Interim or Final)	…..	…..	…..	…..
Total Cash Payments (C)	…..	…..	…..	…..
(D) Surplus (Shortage) (A + B – C)	……	……	……	……
(E) Short – term Financing				
Proceeds of Short-term Borrowings	……	……	……	……
Less: Repayment of short- term borrowings	(……)	(……)	(……)	(……)
Less: Payment of Interest on short-term borrowings	(……)	(……)	(……)	(……)
(F) Closing Cash Balance (D ± E)	…….	……	……	……

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Q: Distinguish between Cash Budget and Cash Flow Statement.
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Ans:

Basis of Distinction	Cash Budget	Cash Flow Statement
Time Span	It is prepared for a week, month, quarter, half year or a year.	It is usually prepared for a year.
Usefulness	It is useful for short-range planning	It is useful for long-range planning

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Q: What is zero- base budgeting (ZBB)? What are its advantages and disadvantages? *(www.prepnext.com)*

Ans:
Zero-base budgeting is the latest technique of budgeting. This technique was first used in America in 1962. The former President of America, Jimmy Carter used this technique when he was the Governor of Georgia for controlling state expenditure.

The normal technique of budgeting is to use previous year's cost levels as a base for preparing this year's budget. This method carries previous year's inefficiencies to the present year. Under zero – base budgeting every year is taken as a new year and previous year's figures are not adopted as a base. As the name suggests, it is starting from a 'scratch', taking zero as a base. The budget of this year will have to be justified according to present situation. Funds required for any activity for the next budget period should be obtained by presenting a convincing case. By delinking the budget from the past, the past mistakes are not repeated.

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In the words of **Peter A Phyrr (known as Father of Zero Base Budgeting)**, " A planning and budgeting process which requires each manager to justify his entire budget request in detail from scratch (hence zero base) and shifts the burden of proof to each manager to justify why he should spend money at all. The approach requires that all activities be analysed in 'decision packages' which are evaluated by systematic analysis and ranked in order of importance."

CIMA, London has defined it "as a method of budgeting whereby all activities are revaluated each time a budget is set. Discrete levels of each activity are valued and a combination chosen to match funds available".

A unique feature of zero-base budgeting is that it tries to help management answer the question. "Suppose we are to start our business from scratch, on what activities would be spend our money and to what activities would we give the highest priority?

Process or Steps Involved in Zero-base budgeting:

The following steps are involved in Zero-base budgeting:

(a) Determining the Objectives of Budgeting: The objective of budgeting should be determined. When the objective is clear, then efforts will be made to achieve that objective. Different organisations may have different objectives. One concern may try to reduce the expenditure on staff, another may try to discontinue one project in preference to another.

(b) Deciding on Scope of Application: The extent to which zero-base budgeting is to be applied should be decided. Whether it should be used for all operational areas or it should be applied in some areas only should be decided beforehand.

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(c) **Developing Decision Packages**: The next step in Zero-base budgeting is developing of 'decision packages'. A decision package is "a document that identifies a specific activity in such a manner that management can evaluate and rank it against other activities competing for limited resources, and decide whether to approve or disapprove it." *While developing a decision package, answers to the following questions would be desirable:*

(i) Is it necessary to perform a particular activity at all? If the answer is in the negative, there is no need to proceed further.

(ii) How much has been the actual cost of the activity and what has been the actual benefit both in tangible as well as intangible forms?

(iii) What should be the estimated cost of the level of activity and the estimated benefit from such activity?

(iv) Should the activity be performed in the way in which it is being performed and what should be the cost?

(d) **Ranking of Decision Packages in the order of priority**: Cost and benefit analysis should be undertaken. We should consider the cost involved and the likely benefit to accrue. Only those projects should be taken first where benefit is more as compared to the cost involved. Cost benefit analysis will help in fixing priority for various projects on the basis of their utility or ranking of decision packages.

(e) **Allocation of Resources in accordance with the ranking**: The final step involved in zero-base budgeting is concerned with selecting, approving decision packages and finalising the budget.

> ***N.B.**: Decision packages are self contained modules or proposals seeking funds. Each Decision Package will clearly explain the activity, the need for the item, the amount involved, the benefit of implementing the proposal, the loss that may be incurred, if it is not done, etc.*

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BENEFITS OR ADVANTAGES OF ZERO-BASE BUDGETING:

There are a number of benefits that arise from zero-base budgeting. Some of the important advantages of ZBB are enumerated below:

(1) It provides a systematic approach to evaluate different activities.

(2) It enables management to rank the different activities in the order of priority and to allocate resources in the order of priority.

(3) It enables management in making optimum allocation of scarce resources. The priority can be fixed for various activities and their implementation will be in the same order.

(4) Zero-base budgeting improves efficiency of the management. Every manager will have to justify the demand for resources. Only those activities will be undertaken which will have justification and will be essential for the business. Past inefficiencies are not repeated.

(5) Zero-base budgeting will help in identifying economical and wasteful areas. Emphasis will be given to economical activities and alternative courses of action will also be studied.

(6) The management will be able to make optimum use of resources. The expenditure will be undertaken only when it will have justification. A list of priorities is prepared and cost-benefit analysis will be the guiding principle in fixing the priority.

(7) Budgeting will be related to organsiational goals. Something will not be allowed on the plea that it was done in the past. Only those things will be allowed which will help in realizing organisational goals.

(8) Zero-base budgeting will be appropriate for the staff and support areas (i.e., non-manufacturing overheads) of an organisation because the inputs of these areas are not directly related to the final outputs of the organisation.

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(9) Coordination within the firm is improved and communication channels are strengthened.

(10) Increased participation in ZBB creates a motivational impact.

(11) ZBB is particularly useful for service departments and Governments.

(12) It makes managers cost conscious and helps them in identifying priorities in the overall interest of the organisation.

LIMITATIONS OF ZERO-BASE BUDGETING:

In spite of many advantages, there are a number of limitations arising mainly from difficulties in operation of ZBB. Some of the important limitations are as below:

1) Computation of cost benefit analysis, which is essential for ZBB, is not possible in respect of non-financial matters.

2) Some activities may have qualitative rather than quantitative benefits. It is very difficult to quantify such activities as research and development and general administration.

3) Difficulties in formulation and ranking of decision packages as every manger may not have the necessary expertise.

4) The system of zero-base budgeting has no scope to adjust for the changes and, thus, flexible budgeting is not possible.

5) It is time consuming because it requires the development of decision packages.

6) It requires a lot of training for managers.

7) *It involves a lot of time and cost of operating ZBB is also very high.*

8) The paper work will increase periodically due to large number of decision packages.

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9) The cost of preparing the various packages may be very high in large firms involving vast number of decision packages.

10) Ranking of packages is very often subjective and may give rise to conflicts.

11) Bad managers may resist new ideas and changes as they feel threatened by ZBB.

12) It may lay more emphasis on short term benefits to the detriment of long term objectives of the organisation.

13) Costs and benefits on each package must be continually up-to-dated to be relevant and new packages are to be developed as soon as new activities emerge.

Q: Differentiate between Traditional Budgeting and Zero Base Budgeting. *(www.prepnext.com)*

Ans:

Traditional Budgeting Vs. Zero Base Budgeting		
Basis of Difference	**Traditional Budgeting**	**Zero –Base Budgeting**
Orientation	It is more accounting oriented than decision oriented. Depends upon past data and lays emphasis on 'how much'.	It is decision oriented. Lays emphasis on 'why'.
Approach	Its approach is monitoring towards expenditures	Its approach is towards achievement of objectives.
Focus	Its focus is on increase or decrease in expenditures over the past.	Its focus is on cost benefit analysis.
Communication	In traditional budgeting, communication is usually vertical.	It encourages communication both vertically and horizontally.

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Method	The method of preparation of traditional budget is based upon extrapolation.	Its preparation is based upon selection of decision package in view of cost-benefit analysis.
Operating Efficiency	It does not promote operating efficiency.	It promotes Operating Efficiency.
Wasteful Activities	It does not identify activities involving wasteful expenditure.	It identifies activities involving wasteful expenditure.
Alternative Means	It does not encourage the managers to identify and evaluate alternative means of achieving the same objectives.	It encourages the managers to identify and evaluate alternative means of achieving the same objectives.
Rational Decision Making	It does not involve rational decision making.	It involves rational decision making.
Priorities	It does not fix any priority	It fixes the priorities
Inefficiencies	It involves carry forwarding of inefficiencies of a prior year	It does not involve carry forwarding of inefficiencies of a prior year.
Review of Existing Activities	It does not involve the review of existing activities.	It involves the review of existing activities.
Process	It involves an adjustment to previous figures in the light of demand for inflation and new proposed programmes.	It involves critical Costs & Benefits Analysis of existing programmes and new proposed programmes, ranking the programmes and allocating the resources in the order of priority.
Manipulation by Manager	It MAY involve manipulation by managers in inflating their budget request so that after the cuts they still get what they want.	It MAY not involve manipulation by managers since the manager has to justify each item of expenditure in its entirety.

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Q: Write short notes:
(i) Performance Budgeting (ii) Responsibility Accounting
(www.prepnext.com)

Ans:

(i) PERFORMANCE BUDGETING:

Performance budgeting is a technique under which Responsibility Centres are established and the targets in terms of physical performance are set for each Responsibility Centre and then expenditures (i.e.. inputs in financial terms) are linked with physical performance (i.e. output in physical terms) and performance is evaluated through Periodic Performance Reports.

In other words, performance budgeting may be described as the budgeting system in which input costs are related to the performance, i.e., end results. It is a system of budgeting which provides for appraisal of performance as well as follow up measures.

Performance budgeting seeks to establish relationship between inputs (costs) and their direct outputs. According to National Institute of Bank Management, Mumbai, performance budgeting technique is, "the process of analysing, identifying, simplifying and crystallising specific performance objectives of a job to be achieved over a period, in the framework of the organisational objectives, the purpose and objectives of the job. The technique is characterized by its specific direction towards the business objectives of the organisation".

Features:

1) The focus is on the work to be done, services to be rendered rather than resources to be spent for or acquired.
2) The emphasis is shifted from control of inputs to efficient and economic management of functions and objectives.
3) It links the inputs of the expenditure (i.e. inputs in financial terms) with the physical performance (i.e. output in physical terms).
4) The evaluation of performance is through Periodic Performance Reports.

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Steps in the Process of Performance Budgeting:

1) Establishment of Responsibility Centres
2) Setting of physical performance targets for each Responsibility Centre
3) Estimating financial requirements to achieve the physical targets
4) Measurement of Actual Performance
5) Continuous comparison of the Actual Performance with the Budgeted Performance
6) Ascertainment of the Variances and analysis of reason therefore
7) Taking the necessary corrective action

PRE-REQUISITES:

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

1) The objectives of the enterprise are spelt out in concrete terms.
2) The objectives are then translated into specific functions, programmes, activities and tasks for different levels of management within the realities of fiscal constraints.
3) Realistic and acceptable norms, yardsticks or standards and performance indicators should be evolved and expressed in quantifiable physical units.
4) A style of management based upon decentralised responsibility structure should be adopted, and
5) An accounting and reporting system should be developed to facilitates monitoring, analysis and review of actual performance in relation to budgets.

Limitations:

1) It is difficult to classify all programs and activities.
2) It is difficult to evaluate all performances in physical terms.

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(ii) RESPONSIBILITY ACCOUNTING:

Responsibility Accounting is a system of accounting under which:

(i) The costs and revenues are accumulated, classified, measured and reported for each responsibility centre, which is under the control of a manager who has direct responsibility for its performance.

(ii) The performance is evaluated by comparing the actual with those budgeted through Periodic Performance Reports.

(iii) The variances are analysed as to fix the responsibility and to take the necessary corrective action.

The basic idea of responsibility accounting is that a manager should be held responsible only for those items over which he can exercise a significant degree of control.

For example, if Mr. A, the manager of a department prepares the cost budget of his department, then he will be made responsible for keeping the budgets under control. A will be supplied with full information of costs incurred by his department. In case the costs are more than the budgeted costs, then A will try to find out reasons and take necessary corrective measures. A will be personally responsible for the performance of his department.

Kohler E.L.: It is "the classification, management, review and appraisal of accounts serving the purpose of providing information on the quality, quantity and standards of performance attained by persons to whom authority has been assigned."

Charles, T. Horngreen, "Responsibility accounting is a system of accounting that recognizes various responsibility centres throughout the organisation and reflects the plans and actions of each of these centres by assigning particular revenues and costs to the one having the pertinent responsibility. It is also called profitability accounting and activity accounting".

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Pre-Requisites for Responsibility Accounting:

1) There should be **clear allocation of authority and responsibility**.
2) There should be **active participation of managers** of responsibility centres in the preparation of budgets.
3) There should be **fixed and practically attainable targets** of performance.
4) There should be a **system of collecting actual and accurate information** on timely basis.
5) There should be a **system of timely evaluation of performance** through Performance Report.
6) There should be a **system of taking the necessary corrective action** (if any) timely.

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STEPS INVOLVED IN RESPONSIBILITY ACCOUNTING:

The following steps are involved in responsibility accounting:

1) The organisation is divided into various responsibility centres. Each responsibility centre is put under the charge of a responsibility manager. The managers are responsible for the performance of their departments.

2) The targets of each responsibility centre are set in. The targets or goals are set in consultation with the manager of the responsibility centre so that he may be able to give full information about his department. The goals of the responsibility centres are properly communicated to them.

3) The actual performance of each responsibility centre is recorded and communicated to the executive concerned and the actual performance is compared with goals set and it helps in assessing the work of these centres.

4) If the actual performance of a department is less than the standard set, then the variances are conveyed to the top management. The names of those persons who were responsible for that performance are also conveyed so that responsibility may be fixed.

5) Timely action is taken to take necessary corrective measures so that the work does not suffer in future. The directions of the top level management are communicated to the concerned responsibility centre so that corrective measures are initiated at the earliest.

ADVANTAGES OF RESPONSIBILITY ACCOUNTING:

The following are some of the advantages of responsibility accounting:

1) Assigning of Responsibility:
Each and every individual in the organisation is assigned some responsibility and they are accountable for their work. Every body knows what is expected of him. Nobody can shift responsibility to any body else if something goes wrong.

2) Improves Performance:
The assigning of tasks to specific persons act as a motivational factor too. The persons incharge for different activities know that their performance will be reported to the top management. They will try to improve their performance. On the other hand, it acts as a deterrent for low performance also because persons know that they are accountable for their work and they will have to explain for their low performance.

3) Helpful in Planning:
Under the system of responsibility accounting, full information is collected about costs and revenues. This data is helpful in planning of future costs and revenues, fixing of standards and preparing of budgets.

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4) Delegation and Control:

This system enables management to delegate authority while retaining overall control. The authority is delegated according to the requirements of the task assigned. On the other hand, responsibility of various persons is fixed which is helpful in controlling their work. The control remains with top management because performance of every cost centre is regularly reported to it.

5) Helpful in Decision-Making:

Responsibility accounting is not only a control device but also helpful in decision-making. The information collected under this system is helpful to management in planning its future actions. The past performance of various cost centres also helps in fixing their future targets. So this system enables management to take important decisions.

6) Increases Morale:

It increases the morale of managers because of:

(a) active participation in the preparation of budgets
(b) linkage of rewards to performance
(c) exclusion of those items which are beyond their control
(d) autonomy in planning and decision-making of their centres.

7) Other Advantages:

(i) It facilitates **effective budgeting** through active participation of managers in the preparation of budgets.
(ii) It facilitates the **effective evaluation** of performance through prompt and timely performance reports.
(iii) It facilitates the **principle of management by objective** (MBO) through evaluation of performance on the basis of already set goals.
(iv) It facilitates the **principle of management by exception** (MBE) by enabling the management to focus on significant matters on the basis of variance analysis.
(v) It develops an atmosphere of cost-consciousness and profit mindedness.

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(vi) It facilitates the optimum utilisation of organisation's resources (i.e. Capital, Human etc.) by various managers, and thereby improves overall profitability.

(vii) It facilitates the effective communication of goals, objectives etc. through budgets to all the managers.

Q: Distinguish between Traditional Budgeting and Performance Budgeting. *(www.prepnext.com)*

Ans:

Basis of Distinction	Traditional Budgeting	Performance Budgeting
More Emphasis	It gives more emphasis on the financial aspect than the physical aspects or performance.	It gives more emphasis on the physical Aspect (or performance) than the financial aspects. It aims at establishing a relationship between the inputs and the outputs.
Preparation	It is prepared with the main emphasis on items of expenditure.	It is prepared with the main emphasis on the functions (objectives) of the organization, the programmes to discharge these functions and the activities which will be involved in undertaking these programmes.

Q: Explain the various control ratios. *(www.prepnext.com)*

Ans:

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CONTROL RATIOS:

The management wants to know whether performance of its business is going as per schedule or not. With this purpose in view some control ratios are used by the management to know whether the deviations of the actual performance from the budgeted performance are favourable or unfavourable. These ratios are expressed in terms of percentages. *If the ratios are 100 % or more, then the performance will be favourable but if these ratios are less than 100%, then the performance will be unfavourable or unsatisfactory.*

The following control ratios are calculated:

(a) Capacity Ratio = (Actual Hours Worked / Budgeted Hours) * 100

This ratio indicates how much budgeted hours have been actually utilized. If the ratio is 80%, then it means that 80% budgeted hours have been utilized and the remaining 20% capacity remains idle.

(b) Activity Ratio = (Standard Hours for Actual Production/ Budgeted Hours) * 100

This ratio shows the level of activity attained during the period.

(c) Efficiency Ratio = (Standard Hours for Actual Production/ Actual Hours Worked) * 100
= (Activity Ratio/ Capacity Ratio)/ 100

This ratio shows the level of efficiency attained during a particular period. If this ratio is 130% then it shows that the efficiency is more by 30% or it has gone up by 30%.

(d) Calendar Ratio = (Number of Actual Working Days in a period/ No. of Working Days in the Budget Period) * 100

This ratio shows whether actual working days are more or less than the budgeted working days. If the ratio is more than 100% then actual working days are more than the budgeted number of working days and vice versa if the ratio is less than 100%.

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