

UNIT-5

Budgetary Control

Objectives of the Unit

- To understand the meaning of budget- its types, budgeting, process of budgeting, etc.
- To know the meaning of budgetary control system, its features, process, advantages and limitations.
- To provide knowledge about zero base budgeting- its advantages and disadvantages, methods of preparing various types of budgets.
- To disseminate the concept of lease financing and the related facts to be used by different organisations in modern times

Structure

- 2.1 Meaning of Budget
- 2.2 Features/characteristics of Budget
- 2.3 Meaning of Budgeting
- 2.4 Meaning of Budgetary control
- 2.5 Objectives/benefits/advantages/uses/significance of Budgetary Control
- 2.6 Pre-requisites of successful budgeting
- 2.7 Limitations of Budgetary Control System
- 2.8 Types of budgets
- 2.9 Zero base budgeting
- 2.1 Procedure of setting up Zero base budgeting
- 2.11 Advantages
- 2.12 Disadvantages
- 2.13 Lease Financing
- 2.14 Features/characteristics of Lease
- 2.15 Types of lease
- 2.16 Difference between finance and operating lease
- 2.17 Determination of Lease Rentals

- 2.18 Financial evaluation from lessors' point of view
- 2.19 Financial evaluation from lessees' point of view
- 2.20 Benefits/advantages of Lease
- 2.21 Disadvantages
- 2.22 Questions for Practice

Introduction

In today's complex business environment a good planning plays a significant role in growth development of an organization. When the plan is converted into numerical terms for setting individual and organizational goals it is known as a Budget. Further, when the business activities are controlled with the help of budgets for the attainment of predetermined goals and objectives, it is known as Budgeted Control System. A good Budgetary Control System helps in reducing the cost by avoiding unnecessary activities and hence results into increased profits of the business organization.

2.1 Meaning of Budget

When the plans of business organisation are expressed numerically or quantitatively it is known as budget. Since, the resources are always scarce hence they are to be used judiciously by the management for attaining the predetermined goals or objectives. A budget helps in doing so by allocating resources to various activities of an organisation.

2.2 Features/Characteristics of Budget:

1. Budget is prepared for the attainment of specific objective.
2. Budget is prepared for a definite future period, for example, for a month, quarter, half year, a year or more.
3. It is prepared well in advance before the commencement of the period for which it is prepared.
4. It is sort of statement expressed numerically/quantitatively and is based on plans of the organization.
5. A budget is prepared by a budget committee.
6. A budget represents the managerial policies to be adopted and implemented by the organization.

2.3 Meaning of Budgeting

The process of preparing budgets by taking various steps is known as budgeting. While budgeting, a budget manual (a bundle of budget policies) is prepared having details regarding the budget to be prepared, a budget controller (budget director or budget officer) is appointed for the purpose and a budget committee is constituted under his chairmanship having members from various departments of the organisation. Sometime outside experts are also appointed as members of budget committee, if needed. The budget period, procedure and key factors are also considered while budgeting.

2.4 Meaning of Budgetary control

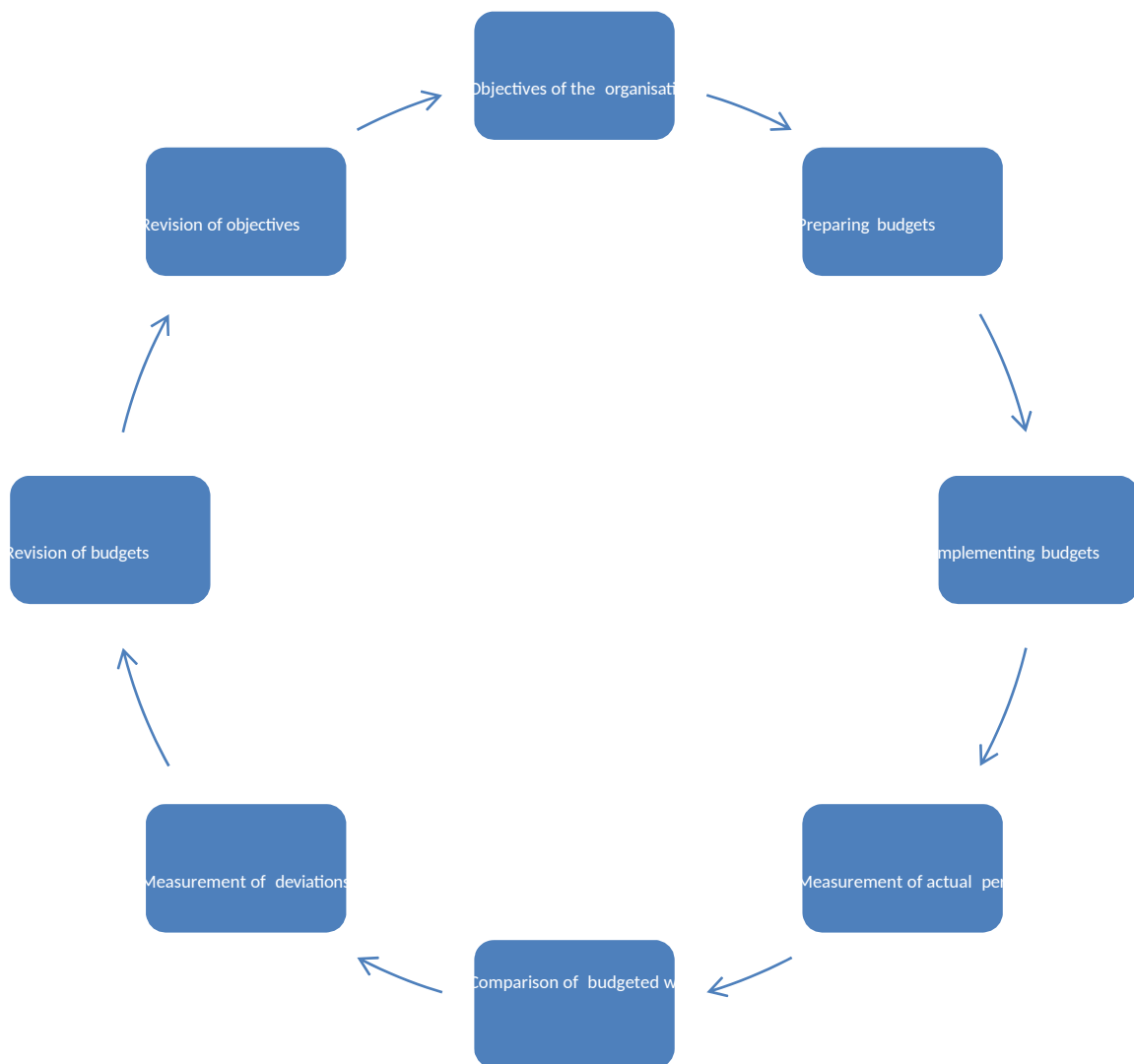
When the business activities are controlled by the management with the help of budgets for the attainment of predetermined objectives of the organisation, it is known as budgetary control/budgetary control system. Under the system, first the budgets are prepared and implemented by the management, actual performance is measured and deviation/ differences with the budgeted performance are calculated and consequently the remedial actions are initiated/ taken for the betterment.

2.5 Objectives/benefits/advantages/uses/significance of Budgetary Control

If someone asks you as why do you wear clothes? Probably you will give the same answer but with different words which suit the language of the question. Hence, when we talk about the objectives/benefits/ you wear clothes or what are the objectives/benefits/advantages/uses/significance advantages/uses/significance of budgetary control the answer will be the same one but by moulding the words as per the language of the questions and the same may be summarized as follows:

1. **Effective planning and fixation of objectives:** It is possible with the budgetary control system to identify and study various types of problems with which the organization is confronting with and consequently the future courses of action in the form of effective planning are possible to be adopted. Similarly, the budgetary control system points out strong and weak points of the organization therefore it is easy to set the objectives for the organization with the help of it.

Figure 2.1 Objectives of Budgetary Control



2. **Better co-ordination:** An organization becomes capable of adopting better coordination among various types of activities performed by it for the accomplishment of

individual/departmental/organizational goals by learning through experiences of budgetary control system which helps in increasing the efficiency of overall organization.

3. **Better utilization of resources:** Limited resources of the organization are allocated judiciously under budgetary control by taking into considerations various types of activities to be performed by different departments for attaining the overall objectives of the organization. In this way, the best use of available resources is made by the management and the individual goals are clearly defined for the use of the same.
4. **Cost control:** Under the system, utmost care is given for the best utilization of resources and consequently attaining the personal and organizational goals as per the budgeted targets. The actual performance is to be compared with budgeted performance and accountability of individuals may be fixed easily, therefore, especial attention is given towards the cost control which ultimately increases the efficiency and effectiveness of the organization.
5. **Increase in revenues:** As with the help of budgetary control system an organization is capable of controlling the cost of its goods and services and hence, by having competitive advantage over its competitors, the selling price is fixed at lower level which consequently helps in increasing the demand of the products by the customers. In this way by making more sales the organization increases its revenue.
6. **More profits:** By adopting the budgetary control technique an organization generates more surpluses by increasing its revenue and controlling its costs. In this way it earns more profits on its capital employed.
7. **Better financial position:** Better earning capacity attained by the organization through adoption of budgetary control system leads to a better financial position of the organization year over year in the form of increased reserves and surpluses and better asset base.
8. **Better control:** Under budgetary control system, the targets are assigned to the employees of the organization in the quantitative terms by preparing budgets. Hence, both the subordinates and superiors are well aware about their duties to be performed and controlled respectively. In this way, the system paves way for better control over various activities of the organization.
9. **Fulfilling Corporate Social Responsibility:** By having better performance in the form of increased rate of return on capital employed and sound financial position, the organization becomes capable of fulfilling its corporate social responsibility towards various stakeholders such as owners, management, creditors, suppliers, bankers, government, society, etc.
10. **Expansion and modernization:** The expansion and modernization of an organization is based on two things – capital and technology which are possible to be created with the help of adoption of budgetary control system by generating more and more profits year over year which leads to more capital formation and heavy assets base. Hence, with the enhanced financial power it is very much possible to expand more amounts on research and development activities and

purchase of latest technology for the growth and development of the organization. Maruti Udyog Limited is the best example to support the point of view.

11. **Employment generation:** The business organization adopting the budgetary control techniques is bound to grow fast and hence create more employment opportunities by expanding its areas of operations.
12. **Better standard of living:** Such types of organization having budgetary control provides better products and other amenities to their stakeholders which leads towards their better standard of living in the form of better food, shelter and clothing, etc.
13. **Economic growth:** If more and more business organizations adopt budgetary control system then there is a possibility of more growth and development in an economy with more profits and better financial positions of the organizations. It may help in abolishing the poverty from the economy by creating more job opportunities.

2.6 Pre-requisites of successful budgeting

The following are the essentials to successful budgetary control techniques:

1. An organization with well defined objectives, appropriate structure, proper classification of activities, clearly defined authority and responsibility etc.
2. A good accounting system having proper records of all the activities and capable of providing necessary information in time.
3. The superiors of the organization should support their subordinates from time to time whenever they are in need of.
4. A management system comprising of reward and punishment is also needed.
5. A better co-coordinating system among the employees and activities of the organization is also needed in the adoption of budgetary control system.

2.7 Limitations of Budgetary Control System

The following are main limitations of budgetary control system:

1. **Lack of co-ordination and co-operation:** If an organization is lacking in co-ordination and co-operation, the budgetary control system may not give desired results.
2. **Stress on the employees:** The system passes on targets to the employees whom they are supposed to attain in any case within a time framework causes stress in the minds of employees leading to ill health and other related issues.
3. **Proper support of top-level management:** For the success and implementation of budgetary control system a proper support from the top- level management is always required
4. **Improper accounting system:** If the accounting system of the organization is not properly maintained then the budgetary control system may not be successful.

5. **Improper control system:** If the control system of the organization is not appropriate and prompt the chances of failure of budgetary control system increase substantially.
6. **Biased attitude of management:** The success of the budgetary control system depends on the fair and honest behavior of the management but if it is biased then the reverse may happen.

2.8 Types of budgets

Budgets may be classified on the basis of:

1. Time
2. Functions
3. Flexibility

Types of budgets on the basis of time:

- a) **Short-term budgets:** These are the budgets which are prepared for a short period ranging from one year to five years.
- b) **Current budgets:** These are very short term budgets such as weekly, fortnightly, monthly and quarterly etc. which are to be implemented in near future.
- c) **Long term budgets:** The budgets which are prepared for a long period (more than five years) of time.

Types of budgets on the basis of functions/functional budgets:

These are the budgets based on the functions of the organisations:

- a) Material Budget
- b) Labour Budget
- c) Production Budget
- d) Overhead cost Budget
- e) Sales budget
- f) Personnel Budget
- g) Plant utilization Budget
- h) Cash Budget
- i) Research and development Budget

j) Master Budget (it is the summary of all functional budgets), etc.

On the basis of flexibility:

- a) **Fixed Budgets:** The budgets which are prepared with fixed standards or level of activities and there is no provision of making change in them.
- b) **Flexible Budgets:** These are the budgets the estimates of which have tendency to be change as per the change circumstances.
- c) **Semi-flexible Budgets:** These are the budgets denoting a part of them not to be changed but some of the estimates have provisions to have changes as per the changed circumstances.

SALES BUDGET

Example 2.1: Shiva Ltd. produces two kinds of products, P and Q and put them for sale in two districts

i.e. Faridabad and Delhi markets. The information related to production and sale of products for the year ending 31st March, 2019 is as follow:

Market	Product	Budgeted Sale	Actual Sale
Faridabad	P	500 at ` 11 each	600 at ` 11 each
	Q	400 at ` 13 each	300 at ` 13 each
Delhi	P	600 at ` 11 each	800 at ` 11 each
	Q	500 at ` 13 each	400 at ` 13 each

It is observed that product P is overpriced while Product Q is underpriced and if price of product P is decreased by Rs. 1 and price of product Q is increased by Rs. 2, then it is estimated that the sale would be increased in following manner:

Product	Faridabad	Delhi
P	10%	10%
Q	20%	5%

Also, it is further estimated that the use of sales promotional scheme would also raise the sales of product as follow:

Product	Faridabad	Delhi
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P	50 Units	40 Units
Q	20 Units	75 Units

Prepare a sales budget including the above estimates for the year ending 31st March, 2020

Solution:Sales Budget for the year ending 31st March, 2020

Market	Product	Current Year Budget			Future Period Budget			Actual Sales		
		Units	Price	Amount	Units	Price	Amount	Units	Price	Amount
Faridabad	P	500	11	5,500	600	10	6,000	600	11	6,600
	Q	400	13	5,200	500	15	7,500	300	13	3,900
	Total	900		10,700	1,100		13,500	900		10,500
Delhi	P	600	11	6,600	700	10	7,000	800	11	8,800
	Q	500	13	6,500	600	15	9,000	400	13	5,200
	Total	1,100		13,100	1,300		16,000	1,200		14,000
Total	P	1,100	11	12,100	1,300	10	13,000	1,400	11	15,400
	Q	900	13	11,700	1,100	15	16,500	700	13	9,100
	Total	2,000		23,800	2,400		29,500	2,100		24,500

CASH BUDGET**Receipts and Payments Method**

Example 2.2: You are required to prepare a cash budget for the month June, July and August for the year ending 31st March, 2020 on the basis of following information:

Month	Credit Sales	Raw Material	Labour Expenses	Manufacturing Expenses
	,	,	,	,

April	2,40,000	1,68,000	20,000	14,000
May	2,60,000	2,00,000	24,000	16,000
June	1,60,000	2,08,000	16,000	12,000
July	2,32,000	2,12,000	20,000	24,000
August	1,76,000	1,60,000	16,000	12,000

1. Balance of cash on 1st June, 2019 is ` 10,000.
2. Machinery purchased of Rs. 50,000 in August, out of which 10 per cent is to be paid in cash while rest is paid after one month.
3. Advance tax is to be paid in the month of June of Rs. 5,000.
4. Credit period allowed as follow: (a) for customers – 2 months, (b) for suppliers – 1 month, (c) for manufacturing expenses – half month.
5. Rent is to be received in the month of July of Rs. 10,000.

Solution:

Cash Budget for the Year ending 31st March, 2020

Particulars	June	July	August
Opening Balance	10,000	9,000	33,000
Budgeted cash receipts:			
Received from Debtors	2,40,000	2,60,000	1,60,000
Rent Received	-	10,000	-
Total Receipts 'A'	2,50,000	2,79,000	1,93,000
Budgeted cash payments:			
Creditors	2,00,000	2,08,000	2,12,000
Labour Expenses	16,000	20,000	16,000
Manufacturing Expenses	14,000	18,000	18,000
Tax paid in advance	5,000	-	-
Machinery Purchased	-	-	5,000
Total Payments 'B'	2,35,000	2,46,000	2,51,000

Closing Balance 'A - B'	9,000	33,000	(58,000)
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Working notes:

1. The closing balance of every month is the opening balance of next month.
2. Labour charges are paid in the month in which it incurred.
3. Half of the manufacturing expenses of the month May and half of June will be paid in the month of June and so on: $\frac{1}{2} (16000) + \frac{1}{2} (12000) = 14000$, $\frac{1}{2} (12000) + \frac{1}{2} (24000) = 18000$ and so on.

FLEXIBLE BUDGET

Example2.3: A factory in Nelco Motor Co. currently produces 5,000 units while working at 50% capacity. At 80% capacity, cost of material will raise 2% and selling price will be go down by 2%. Also, at 100% capacity cost of materials move up by 5% and selling price will be move down by 5%.

The selling price of the product is ` 300 per unit at 50% capacity and cost per unit is as follow:

Materials	150
Labour	40
Work Expenses (60% variable)	20
Administration and office Expenses (50% variable)	<u>40</u>
	<u>250</u>

Help Nelco Motor Co. in estimating its profits when it works at 80% and 100% of its capacity

Solution:**FLEXIBLE BUDGET**

	Existing	Proposed	
Level of Activity	50%	80%	100%
No. of Units	5,000	8,000	10,000
<i>Variable Costs:</i>			
Material	7,50,000	12,24,000	15,75,000
Labour	2,00,000	3,20,000	4,00,000
Work Overhead	60,000	96,000	1,20,000
Administration and office overhead	1,00,000	1,60,000	2,00,000
Total Variable Costs....(i)	11,10,000	18,00,000	22,95,000
<i>Fixed Costs:</i>			
Work Overhead	40,000	40,000	40,000

Administration and office overhead	1,00,000	1,00,000	1,00,000
Total Fixed Costs... (ii)	1,40,000	1,40,000	1,40,000
Total Costs (i)+(ii)	12,50,000	19,40,000	24,35,000
Sales Value	15,00,000	23,52,000	28,50,000
Profit	2,50,000	4,12,000	4,15,000

Example 2.4: The Prepare a cash budget of ABC Ltd. using adjusted profit and loss method on the basis of following information:

BALANCE SHEET

as at 31st March, 2019

<i>Liabilities</i>	`	<i>Assets</i>	`
Equity Share Capital	2,00,000	Building	1,00,000
Reserve	40,000	Machinery	50,000
Accumulated Profit	20,000	Trade receivable	80,000
Trade payable	1,00,000	Inventory	40,000
Bills Payable	20,000	Bills Receivables	10,000
Outstanding interest	4,000	Prepaid rent	2,000
		Bank Balance	
			<u>1,02,000</u>
	<u>3,84,000</u>		<u>3,84,000</u>

PROJECTED TRADING AND PROFIT AND LOSS ACCOUNT

As on 31st March, 2020

	`		`
To Opening Stock To Net	40,000	By Sales	4,00,000
Purchases To Carriage	3,00,000	By Closing Stock	30,000
To Gross Profit c/d	4,000		
	86,000		
To Interest To Salaries	4,30,000		
To Depreciation			<u>4,30,000</u>
(10% on building and Machinery)	6,000	By Gross Profit b/d	86,000
	12,000	By miscellaneous Receipts	10,000

To Interest		15,000
(Less) Outstanding Interest	12,000	
(Add) Outstanding interest To Rent	<u>(4,000)</u>	
	8,000	
(Add) Prepaid rent		10,000
	<u>2,000</u>	
	6,000	
	2,000	8,000
To carriage outwards		4,000
To Advertisement		2,000
To Net Profit carried down		39,000
		<u>96,000</u>

96,000

To Preference Dividends	16,000	By last year profit	20,000
		By Net Profit for current	
To transfer to Reserve	8,000	year	39,000
To Balance transferred to			
balance sheet	35,000		
	59,000		59,000

Balances at the end are as follow:

Equity Share Capital ` 2,20,000, 7% Loan ` 50,000, Trade payable ` 80,000, Trade receivable
` 1,20,000, Bills Payable ` 22,000, Bills Receivables ` 4,000, Fixtures ` 25,000, Vehicles ` 40,000.

Vehicles and fixtures are purchased at the closing of the year.

Solution:

Cash Budget as on 31st March, 2019

Opening Balance		1,02,000
Add: Current year Net Profit	39,000	
Depreciation	15,000	
Decrease in Bills Receivables	6,000	
Increase in Bills Payable	2,000	
Issue of Equity Shares Capital	20,000	
Issue of Loan	50,000	
Decrease in Prepaid Rent	2,000	
Decrease in inventory	10,000	1,44,000
		2,66,000
Less: Purchase of Machinery	40,000	
Purchase of Fixtures	25,000	

Management Accounting		37
Increase in Trade receivable	40,000	
Decrease in Trade payable	20,000	
Decrease in Outstanding interest	2,000	
Preference Dividends	16,000	1,63,000
Closing Balances as at 31st March, 2020		83,000

Balance Sheet Method

Example 2.5: According to the previous example, prepare the cash budget using balance sheet method.

Solution:

BUDGETED BALANCE SHEET

as at 31st March, 2020

Liabilities		Assets		
Equity Share Capital	2,20,000	Premises	1,00,000	
7% Loan	50,000	Less: Depreciation	10,000	90,000

Reserve Accumulated Profit	48,000	Machinery	50,000	
Trade payable	35,000	Less: Depreciation Fixtures		45,000
Bills Payable Outstanding	80,000	Trade receivable		25,000
Interest	22,000	Bills Receivables Vehicles		1,00,000
	2,000	Inventory		4,000
		Bank (Balancing		40,000
	4,57,000	Figure)		

MASTER BUDGET

A specimen of master budget is as follows:

MASTER BUDGET

Period... Normal Capacity..... Budgeted Capacity.....

	Product X	Product Y	Product Z	Total
Sales (A)	60,000	80,000	1,00,000	2,40,000
Cost of Sales (B):				
Raw Materials Direct Wages	10,000	12,000	14,000	36,000
Manufacturing Expenses Factory Expenses (Fixed)	10,000	8,000	6,000	24,000
	8,000	6,000	8,000	22,000
Add: Opening Stock of material	10,000	10,000	12,000	32,000
Less: Closing Stock of material Gross Profit (C = A - B)	38,000	36,000	40,000	1,14,000
Less: Other Expenses (D)	10,000	4,000	8,000	22,000
Office Expenses	48,000	40,000	48,000	1,36,000
Sales promotion expenses	8,000	8,000	4,000	20,000
	40,000	32,000	44,000	1,16,000
Net Profit (C - D)	20,000	48,000	56,000	1,24,000
Assets:	10,000	10,000	10,000	30,000

Management Accounting	39			
Non Current Current	6,000	10,000	10,000	26,000
Total capital employed	16,000	20,000	20,000	56,000
	4,000	28,000	36,000	68,000
	40,000	40,000	60,000	20,000
	30,000	36,000	24,000	10,000
	70,000	76,000	84,000	30,000

**You are required to fill up the columns given below.*

Ratios

Net Profit/ Total Capital employed	.....	.....	.....	.....
Net Sales/ Total Capital employed	.....	.....	.....	.....
Net Profit/Sales	.....	.....	.....	.....
Current Ratio	.....	.....	.....	.....
Quick Ratio	.....	.....	.....	.....

Appropriation of profit

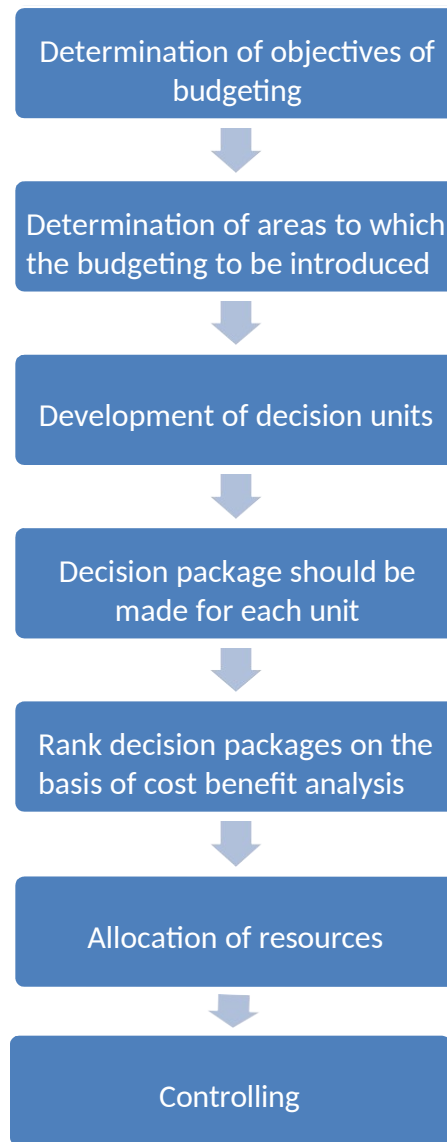
Preference and Equity Dividends	.....	.....	.....	.....
Transfer to Reserves	.....	.....	.....	.....
Balance of profit of loss	.....	.....	.....	.....

2.9 Zero base budgeting

As the name suggests is beginning from zero base or 'De nova budgeting'. It is a process of preparing budgets from scratch or from the zero base. It is based on the underlying assumption that the previous year was zero. Here manager has to give justification of all expenses included in the budget. Process involves first step being recognizing department/segment/organisation activities as decision package then systematic analysis is conducted to evaluate the same and ranking them in order of significance.

Zero base budgeting is a shift from the traditional method of budgeting where former is based on programme oriented and decision oriented approach and latter on functionally oriented spending approach.

2.10 Procedure of setting up Zero base budgeting



2.11 Advantages

1. It ensures better utilization of organization resources as it works on the requirements and benefits.
2. It ensures that manager undertake programs that are indispensable for an enterprise and being performed in effective way.
3. It assists management in approving the budget on the ground of cost benefit analysis.
4. It helps managers in identifying uneconomical activities and proposes the alternative ways of performing activities.

5. It helps in increasing coordination and communication among the segment/department of the organization.
6. It is suitable in service department.

2.12 Disadvantages

It requires identification and development of decision packages which is time consuming process and involves a paperwork at large scale.

In case benefits cannot be determined of decision packages then their ranking is not possible which cause a problem in zero base budgeting process.

This approach of budgeting requires trained and skilled manpower causing it to be an expensive activity.

This approach of budgeting requires managers of decision units to be equipped with the idea behind the concept of zero base budgeting and training in the process of its introduction and effective implementation.