8. BUDGETING ANALYSIS

This chapter covers the following topics:

- Budget, budgeting, and budgetary control
- Flexible budget vs Fixed budget
- Preparation of Simple flexible budget
- Preparation of Simple cash budget

Definition

We are all well-familiar with the term **budget**. Budgeting is a powerful tool that helps the management in performing its functions such as planning, coordinating, and controlling the operations efficiently. The definition of budget is,

> *A plan quantified in monetary terms prepared and approved prior to a define period of time usually showing planned income to be generated and/or expenditure to be incurred during the period and the capital to be employed to attain a given objective.*
>
> *---CIMA, England*

Budget, Budgeting, and Budgetary Control

Let us go through the terms sequentially.

Budget

Budget represents the objectives of any organization that is based on the implication of forecast and related to planned activities.

Budget is neither an estimate nor a forecast because an estimation is a predetermination of future events, may be based on simple guess or any scientific principles.

Similarly, a forecast may be an anticipation of events during a specified period of time. A forecast may be for a specific activity of the company. We normally forecast likely events such as sales, production, or any other activity of the organization.

On the other hand, budget relates to planned policy and program of the organization under planed conditions. It represents the action according to a situation which may or may not take place.

Budgeting

Budgeting represents the formation of the budget with the help and coordination of all or the various departments of the firm.

Budgetary Control

Budgetary control is a tool for the management to allocate responsibility and authority in planning for future and to develop a basis of measurement to evaluate the efficiency of operations.

A budget is a plan of the policy to be pursued during a defined time period. All the actions are based on planning of budget because budget is prepared after studying all the related activities of the company. Budget gives a communication ground to the top management with the staff of the firm who are implementing the policies of the top management.

Budgetary control helps in coordinating the economic trends, financial position, policies, plans, and actions of an organization.

Budgetary control also helps the management to ensure and control the plan and activities of the organization. Budgetary control makes it possible by continuous comparison of actual performance with that of the budgets.

> *Budgets are the individual objectives of a department whereas budgeting may be said to be the act of building budgets. Budgetary Control embraces all this and in addition, includes the science of planning the budgets themselves and utilization of such budget to effect an overall management tool f or the business planning and control.*
>
> *...Rowland and William*

Types of Budgets

Budgets can be categorized in various ways. Let us go through the types of budgets in detail.

Functional Budgets

It relates to any function of the firm such as sales, production, cash, etc. Following budgets are prepared in functional budgets:

- Sales Budget
- Production Budget
- Material Budget
- Manufacturing Budget
- Administrative Cost Budget
- Plant Utilization Budget
- Capital Expenditure Budget

- Research and Development Cost Budget
- Cash Budget

Master Budget or Summarized Budget or Finalized Profit plan

This budget is very useful for the top management of the company because it covers all the information in a summarized manner.

Fixed Budget

It is a rigid budget and is drawn on the assumption that there will be no change in the budget level.

Flexible Budget

It is also called a sliding scale budget. It is useful in:

- the new organizations where it is difficult to foresee,
- the firms where activity level changes due to seasonal nature or change in demand,
- the industries based on change of fashion,
- the units which keep on introducing new products, and
- the firms which are engaged in ship-building business.

Zero Base Budgeting

Zero base budgeting is not based on the incremental approach; previous year figures are not adopted as base.

CIMA has defined it as:

> *As a method of budgeting, where all activities are revaluated each time a budget is set, discrete levels of each activity are valued and combination is chosen to match the funds available.*

Control Ratios

Following ratios are used to evaluate the deviations of the actual performance from the budgeted performance. If the ratio is 100% or more, it represents favorable results and vice-a-versa.

$$\text{Capacity Ratio} = \frac{\text{Actual hours worked}}{\text{Budgeted hours}} \times 100$$

$$\text{Activity Ratio} = \frac{\text{Standard hours for actual production}}{\text{Budgeted hours}} \times 100$$

$$\text{Efficiency Ratio} = \frac{\text{Standard hours for actual production}}{\text{Actual hours worked}} \times 100$$

$$\text{Calendar Ratio} = \frac{\text{Number of actual working days in a period}}{\text{Number of working days in the budgeted period}} \times 100$$

Flexible Budget v/s Fixed Budget

Points	Flexible Budget	Fixed Budget
Flexibility	Due to its nature of flexibility, it may be quickly re-organized according to the level of production.	After the commencement of a period, fixed budget cannot change according to actual production.
Condition	Flexible budget may change according to change in conditions.	Fixed budget is based on the assumption that conditions will remain unchanged.
Cost Classification	Classification of costs is done according to the nature of their variability.	It is suitable for fixed costs only; no classification is done in fixed budget.
Comparison	Comparisons of actual figures with revised standard figures are done according to change in the production level of a concern.	If there is change in production level, then it is not possible to do a correct comparison.
Ascertainment of cost	It is easy to ascertain costs even at different levels of activity.	If there is change in the production level or circumstances, it is not possible to ascertain costs correctly.
Cost Control	It is used as an effective tool to control costs.	Due to its limitations, it is not used as cost control tool.

Flexible Budget

Flexible budget provides logical comparison. The actual cost at the actual activity is compared with the budgeted cost at the time of preparing a flexible budget. Flexibility recognizes the concept of variability.

Flexible budget helps in assessing the performance of departments in relation to the activity level achieved. Cost ascertainment is possible at different levels of activities. It is also useful in fixation of price and preparation of quotations.

Example

With the help of the following given expenses, prepare a budget for production of 10,000 units. Prepare flexible budgets for 5,000 and 8,000 units.

Costs	Price per Unit (Rs)
Material	75
Labor	20
Variable Factory Overheads	15
Fixed Factory Overheads (Rs 50,000)	5
Variable Expenses (Direct)	6
Selling Expenses (20% Fixed)	20
Distribution Expenses (10% fixed)	10
Administrative Expenses (Rs 70,000)	7
Total cost of Sale per unit	158

Solution:

Particulars	Output 5000 units		Output 8000 units	
	Rate (Rs)	**Amount**	**Rate (Rs)**	**Amount**
Variable or Production Expenses:				
Material	75.00	3,75,000	75.00	6,00,000
Labour	20.00	1,00,000	20.00	1,60,000
Direct Variable Overheads	6.00	30,000	6.00	48,000
Prime Cost	**101.00**	**5,05,000**	**101.00**	**8,08,000**
Factory Overheads:				
Variable Overheads	15.00	75,000	15.00	1,20,000
Fixed Overheads	10.00	50,000	6.25	50,000
Works Cost	**126.00**	**6,30,000**	**122.25**	**9,78,000**
Fixed Administrative Expenses	14.00	70,000	8.75	70,000
Cost of Production	**140.00**	**7,00,000**	**131.00**	**10,48,000**
Selling Expenses:				
Fixed 20% of Rs.20/-	8.00	40,000	5.00	40,000
Variable Cost 80% of Rs.20/-	16.00	80,000	16.00	1,28,000
Distribution Expenses:				
Fixed 10% of Rs. 10/-	2.00	10,000	1.25	10,000
Variable 90% of Rs.10/-	9.00	45,000	9.00	72,000
Total Cost of Sale	**175.00**	**8,75,000**	**162.25**	**12,98,000**

Cash Budget

Cash budget comes under the category of financial budget. It is prepared to calculate budgeted cash flows (inflows and outflows) during a specific period of time. Cash budget is useful in determining the optimum level of cash to avoid excessive cash or shortage of cash, which may arise in future.

With the help of cash budget, we can arrange cash through borrowing funds in case of shortage, and we may invest cash if it is present in excess.

It is necessary for every business to keep a safe level of cash. Being a part of master budget, the following tasks are included in a cash budget:

- Collection of Cash
- Cash payments
- Selling Expenses and administrative expensive budget

Format:

If a firm wants to maintain cash balance of Rs 50,000 and in case of shortage the firm borrows funds from Bank, following cash budget is prepared:

Particulars	**Q-1**	**Q -2**	**Q-3**	**Q-4**	**Total**
					(Yearly)
Opening Cash Balance	40,000	50,000	50,000	50,500	40,000
Add; Cash receipts	80,000	1,00,000	90,000	1,25,000	3,95,000
Total available Cash (A)	**1,20,000**	**1,50,000**	**1,40,000**	**1,75,500**	**4,35,000**
Less: Cash Payments:					
Direct Material	30,000	40,000	38,000	42,000	1,50,000
Direct Labour	12,000	15,000	14,000	16,000	57,000
Factory Overheads	18,000	19,000	17,000	20,000	74,000
Administrative Expenses	16,000	16,000	16,000	16,000	64,000
Selling & Distribution Exp.	9,000	10,000	11,000	12,000	42,000
Purchase of Fixed Assets	-	-	40,000	-	40,000
Total Cash Payments (B)	**85,000**	**1,00,000**	**1,36,000**	**1,06,000**	**4,27,000**
Cash in hand C (A-B)	**35,000**	**50,000**	**4,000**	**69,500**	**8,000**
Financing Activities:	15,000	-	50,000	-	65,000
Borrowings		-	-3,000	-18,000	-21,000
Repayments of Borrowings		-	-500	-1,500	-2,000
Interest paid					
Net Cash Flows from financing	23,000	0	46,500	-19,500	50,000
Activities (D)					
Closing Cash Balance E (C+D)	**58,000**	**50,000**	**50,500**	**50,000**	**50,000**