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Department of Management

3rd Year Financial Management

BUDGETING

1. Definition of Budgeting:

According to Certified Institute of Management Accountants (CIMA) a budget is a "quantitative expression of a plan for defined period of time. It may include planned sales volumes and revenues, resources quantities, costs and expenses, assets, liabilities and cash flow". Therefore, to call a plan – budget, it must comprise the quantities of economic resources to be allocated and used, it must be made for certain period of time, it has to be expressed in monetary terms, the managers needs to act in a way that shows intention to realize the plan. Budgeting is a process of expressing quantified resource requirements (amount of capital, amount of material, number of people) into time-phased goals and milestones.

2. Purpose of Budgeting:

Budget helps to aid the planning of actual operations by forcing managers to consider how the conditions might change and what steps should be taken now and by encouraging managers to consider problems before they arise. It also helps co-ordinate the activities of the organization by compelling managers to examine relationships between their own operation and those of other departments. Other essentials of budget include:

- To control resources
- To communicate plans to various responsibility center managers.
- To motivate managers to strive to achieve budget goals.
- To evaluate the performance of managers
- To provide visibility into the company's performance
- For accountability

3. The requirements for effective Budgeting:

- There should be a recognised organization for budgeting with all lines of authority and responsibility definitely allocated and defined.
- The budget should sharply mark the responsibilities of each section of the business.
- Since a budget is based on estimates of sales, cost, etc., they should take good care to make estimates.
- We should make a budget flexible, so that they may incorporate unavoidable changes if needed.
- Cost account data should be used for forecasting purposes.

4. What is Budgetary control:

Budgetary control makes use of budget for planning and controlling all aspects of producing and selling products or services. It attempts to show the plans in financial terms.

The budgetary control when applied to a business as a whole or different section within the business, compares actual performance and the predicted performance and thus enables all levels of management and supervision to know how their sections are moving towards the achievements of budgeted targets.

Budgetary control attempts to bring actual performance at par with the predicted performance by keeping a strict supervisory eye on the actual performance and by exercising control if necessary.

Control follows planning and coordination. Deviation from the predicted plan or performance is noticed by comparing actual and budget performance and cost. The difference between the two figures, the variances are analysed, and they took quickly an action at the right time and right place to correct the actual performance as per predicted performance.

5. Types of Budgeting:

There are 4 common types of budgets that businesses use

a. Incremental Budgeting:

Incremental budgeting takes last year's actual amounts and adds or subtracts a percentage to create the new year's budget. It is the most simple method of budgeting because it is simple and easy to understand. Incremental budgeting is convenient to use if the primary cost drivers do not change from year to year.

Management goes for this type of budgeting if it does not require too much time on preparing budgets. Also, businesses go for this approach if they don't need to carry thorough re-assessment of the operations.

However, there are some disadvantages with using incremental budgeting:

- When there are considerable structural changes in the business or changes in its environment that call for much more effective budget alterations.

- Since an incremental budget allots most funds to the same uses each year, it is hard to get a huge funding allocation to direct at a new project.
- It is also possible to ignore external drivers of action and performance. For example, there is very high inflation in certain input costs. Incremental budgeting ignores any external influences and simply assumes the cost will grow by, for example, 10% this year.
- This type of approach may discourage the construction of innovative ideas.

b. **Activity-based Budgeting:**

Activity-based budgeting (ABB) is a system that records, investigates, and analyzes activities that lead to costs for a business. They checked every activity in an organization that incurs a cost for potential ways to create efficiencies. Budgets are then developed based on these results.
Adopting activity-based budgeting (ABB) can help businesses to reduce the activity levels required to generate sales. Eliminating unneeded costs should increase profitability.

c. **Value proposition Budgeting:**

Value proposition budgeting is an attitude about ensuring that everything that is included in the budget delivers value for the company.

In value proposition budgeting, the budgeter considers the following questions:

- Why is this fund included in the budget?
- Does the item create value for customers, employees, or other stakeholders?
- Does the value of the item overshadow its cost? If not, then is there any other reason why the cost is justified?

Value proposition budgeting targets to avoid unnecessary expenses, although it is not as precisely aimed at that goal as our final budgeting option (zero-based budgeting).

d. **Zero-based Budgeting:**

Zero-based budgeting begins with the assumption that all division budgets are zero and must be rebuilt from scratch. Managers must be able to justify every single expenditure. No expenses are automatically "okayed". Zero-based budgeting is extremely tight, aiming to avoid all expenditures which are not considered true essential to the business's successful operations.
Streamlining spending and focusing on those items that directly make a profit for your business through more value, greater efficiency, cost reductions etc. supports continuous improvement over time.

6. Advantages of Budgeting:

- Policy, plans and actions are all reflected in the budgetary control system. There is a formal recognition of the targets which the business hope to achieve.
- Budgeting makes for better understanding, coordination and harmony of action in a business enterprise because all departments takes part in the process.
- The targets, goals and policies are clearly defined.
- It provides management with a guide of daily activities; thus helps in determining performance and efficiency of each department, there by leading to improvement.
- It informs management the progress made towards achieving the predetermined objectives.
- Total capital required, and we can estimate price of an item in advance.

7.Limitations of budgeting:

- Since the budget is based on estimates, that means estimated sales, estimated costs, estimated business conditions, etc. It may need periodic revisions because estimates may not come out to be 100% true.
- A budget cannot work until the desire to make it work is established in the minds if person working in the different sections of a business concern.