

These statements, therefore, merely provide a guideline. An intelligent reader, nonetheless, should not get scared of these limitations. He can take them in his stride. These limitations do not, in any case, make the tools useless. They just add a *Pinch of Salt* to an otherwise obvious conclusion.

## BUDGETARY CONTROL

### NEED FOR PLANNING

Everyone makes plans. A group of people who do not act with respect to some plans exhibit characteristics of an incoherent, purposeless crowd. They do not constitute an organization in the correct sense of the term.

Different people plan differently. Some plan in their minds, others roughly on bits and pieces of paper, and still others in an orderly and systematic fashion. The term budgeting refers to the last process.

Commercial Organizations have added various dimensions to the forms of budgeting. They have moved away from expenditure budgeting to budgets encompassing the totality of the operations. They prepare cash flow budget, profit and loss budget and also have budgeted Balance Sheet. The Physical Indicators of Performance are also budgeted e.g. Capacity Utilization.

### Advantages of Budgeting

Budgeting is advantageous to management in various ways. Its functions and purposes can be summarized as follows:

1. Budgeting Integrates various activities handled by a variety of people in the organization and studies their combined effect on the profits.
2. It helps to Identify the areas where Further Action is needed.
3. It creates Better Understanding and Communication amongst the people.
4. It helps to draw out profit plans and to Rationally Allocate Resources.
5. It necessitates specification of Objectives, setting up Yardsticks to measure their achievements and consideration of Alternate Plans to allocate resources on a rational basis.

6. Budgeting serves as an Instrument of Control. It provides a means of measuring actual achievements against plans and analyzing the causes for deviations, so that it can be determined whether the original plans themselves were sound or not, or whether plans were sound as to require some corrective action to bring actuals in line with the plans.

#### Types of Budgets

There is a wide diversity in the types of budgets. Broadly, there are three types of budgets:

- a. Operating Budget – plans for operations for a specified forthcoming period.
- b. Cash Budget – showing the anticipated sources and uses of cash.
- c. Capital Budget – showing planned changes in fixed assets.

#### Operating Budget

Budgets are prepared separately for different functions (sales, purchases, production, administration, etc). They are combined to give an overall budget (operating budget) which highlights the profits that would be generated by the interplay of various budgets. This is also broken down into budgets for different products and/or programmes.

Many a times, organizations are divided into various departments/divisions. Each of them is supposed to generate profits.

Even a division is often sub-divided into various product ranges and profitability of each product range is arrived at separately. *For example*, profitability of cotton fabrics, suitings and polyester fabrics can be computed separately in the textile division.

These are called '*Profit Centres*'. Some organizations call them '*Business Units*'. A clear authority and responsibility is required to be given to the person heading this centre/unit. Accounting records also have to be suitably maintained. It is often found advisable to evaluate the performance of profit centres based upon the 'Contribution' generated by them. This saves the labour of detailed allocation of overheads.

Similarly, some *notional transfer pricings* are also introduced to collect required data. When one division consumes/uses the products/services of the other division, the user division is charged the price of the product/service. This is called '*Transfer Price*'.

Profit centre accounting requires a good degree of planning in accounting procedures. But it is certainly useful in evaluating performance. At times, return on investment made in the profit centre is taken as criteria for performance evaluation. The centre head naturally is given flexibility to suggest addition of investment or disinvestment in his centre. This is then called an '*Investment Centre*' or a '*Strategic Business Unit*'.

Budgets, naturally, are accordingly prepared for each profit centre/investment centre, forming part of the overall operating budget.

#### Cash Budget

The Operating Budget and Budgeted Balance Sheet can be translated in terms of *cash receipts* and *cash payments*. This is the '*Cash Budget*'. Inadequate cash planning can be a major reason for the organization not being able to achieve its objectives.

#### Capital Budget

A '*Capital Budget*' consists of a list of new capital assets which management considers worthwhile to acquire together with the estimated cost of such acquisitions and sources of financing them. The capital budget is sometimes prepared independently of the operating budget and at a different point of time.

Capital expenditure proposals may originate anywhere in the organization. These are initially screened and only the most worthwhile ones gets incorporated in the capital budget. At the final approval meeting, usually at the highest level of the organization, individual projects are considered in relation to funds available and their projected returns. We have discussed the aspect of capital budget in our chapter on 'Analysis Of Capital Expenditure'

#### Principles of Budgeting

A sound and effective budget is generally based on the following principles:

1. The budget should evolve from careful consideration and evaluation of alternative courses of action. Budgeting in any organization is done on the basis of several assumptions which must be clearly stated. Contingency plans should be drawn if it is believed that some major or critical assumptions may not materialize.
2. The overall organizational plan must be supported by well documented subordinate plans for each sub-activity.

3. The budget must be geared as per organizational philosophy and structure. To elaborate:
  - a. The budget must be sponsored by Management. The organization must regard it as a Tool of Management and not primarily a Financial Device.
  - b. All managerial and supervisory personnel must actively participate in the budget formulation. They should agree on reasonable budget goals.
  - c. The budget should be built up by responsibility centres, i.e., organizational sub-units. They should show clearly the controllable factors in each centre.
  - d. A thorough understanding and appreciation of budgeting is a continuous and time consuming affair. To some extent, this can be achieved through written manuals or notes, periodic discussions, and meetings to discuss the preparation of the budget and to discuss actual results achieved.
  - e. The budget should cover a reasonable and practical time period.
  - f. The budget should reflect reasonably attainable goals not too high as to be frustrating, yet not too low to promote complacency.
  - g. The staff function of facilitating the budget process should not be confused with the line function which is to make plans. Line managers draw up plans, finance people only assist line managers in making such plans.
  - h. Review of budget estimates by successively higher levels of management must be thorough. Casual and hurried reviews indicate that top management itself is not seriously interested in the budgeting process.
  - i. Final approval of the budget should be specific and should be communicated to different organization units.
  - j. The assumption underlying the budget should be clearly communicated and understood. They only a meaningful comparison of budget against actuals can be carried out and corrective action taken.
  - k. The objective of budgeting should not be to prepare more financial data. Many important, qualitative and quantitative physical indicators of performance should also be budgeted for

e.g., capacity utilizations, machine efficiency, manpower strength, etc.

Although these are directly reflected in financial performance, it is advisable to emphasize them because they are key indicators of performance.

### *Points to Ponder*

1. Can different industries have different key indicators of performance?

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### BUDGETING AND REPORTING OF PERFORMANCE

1. Just as the preparation of budgets is best done on a decentralized basis, it follows, therefore, that the reporting system should be designed to feedback data on performance and comparisons with budgets on the same basis. This involves the concept of Responsibility Reporting. This is also called *Management information system (MIS)*
2. Performance Reports (or MIS Reports) should focus on the overall performance in terms of value of accomplishments versus total costs. Thus it is more important to see how well a task was accomplished and not whether the expenditure was within the limits.
3. Actual results should be collected on the basis of Same Definitions and Concept that are used in formulating the budget and standards of performance.
4. To the extent possible, the reports should highlight Exceptional Items, where actual performance is significantly above or below expected performance.
5. The reports should be Objective, Timely, Clear, and be capable of Easy Understanding. If possible, they should be accompanied by explanations.

Unnecessary and routine reports should not be allowed to creep into the system and, if necessary, periodically unnecessary reporting should be eliminated.

Short but specific reports tend to be 'read' and follow up. Large quantum of data should thus be avoided.

6. Budgeting or budgetary control should not be used only as a whipping stick. Positive Performance should be highlighted and appreciated. It is, in other words, a carrot and stick approach.
7. Budgeting is not a mere Financial Exercise. Finance people work on a staff function. They help line people in introducing and implementing the budgetary control. It is the role and responsibility of the people in the line function to have proper and effective budgetary controls. Finance people should help them in doing so. It is therefore a joint responsibility of line and staff functions to make budgeting an effective tool.
8. The exercise of Budgeting and reporting performance should be done within a Strict Time Frame. An intelligently approximated data, received on time, is much more important than a precise but delayed report.

### *Points to Ponder*

2. Can 'budgeting' ensure cost control? If Yes, how?
3. What is a Balanced Scorecard?

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## SOME MORE PONDERINGS

1. What role would the recent IT revolution play in the field of Financial Management?  
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2. What will be the effect of e-commerce on accounting and Financial Management?  
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3. What are primary and secondary markets? How do they help in Financing Projects?  
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4. How share prices are determined? What are Indexes, Charts, IDerivatives, Mutual Funds?  
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5. What is SEBI? What role does it play in capital markets?  
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6. What are 'tips' that one gets about investments? Should one follow them?  
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7. What is an ideal portfolio for an Individual Investor?  
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8. What are ECBs, ADRs, GDRs, Euro Issues?  
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9. What role does taxation play in financial management? What is tax planning?  
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