

BUDGET

Budgets are future plans of a business expressed in monetary or financial terms.

PURPOSE OF BUDGETING

1. Planning
2. Resource allocation
3. Setting targets to be achieved
4. Co-ordination
5. Monitoring and control
6. Modifying (it occurs when the budgeted plans have not been achieved. You modify any activity i.e. causing any adverse or negative variance).

LIMITATIONS OF BUDGETING

1. It is based on estimations and predictions which might go wrong as future is always uncertain.
2. It is time – consuming.
3. If the budgets are made in a wrong manner due to any reason then serious problems can occur as far as the resource allocation, co – ordination and monitoring is concerned.
4. Budgets are restricting in nature.
5. Sometimes demotivating for the workers.
 - creativity is limited
 - too high targets
 - too low targets – workers can't achieve full potential

HOW TO MAKE BUDGETS

1. An environmental analysis revolving around organizational objectives is conducted and then we set new organization objectives.
2. Finding out the key factors that influence the budget.
 - output and sales is the key factor
3. Departmental or functional budgets are made. (cash budget, marketing budget, research and development budget, administrative budgets) etc. each department makes its own.
4. Co – ordination amongst the departments through meeting
5. Preparation of the master budget (name, given collectively to the projected profit and loss account and balance sheet).

WAYS TO SET BUDGETS

1. Incremental budgeting.
2. Zero –based budgeting.
Incremental is just justifying changes in the last year's budget.
Zero – based is justifying budgets right from the scratch.

TYPES OF BUDGETS

1. Fixed Budgets – changes in output level are not incorporated.
2. Flexible Budgets – changes are included giving greater accuracy.

Variance Analysis – analysis of the difference between the budgeted and the actual value. It is conducted on each single factor to see the direction it takes towards the profits.

Q.1. Differentiate between incremental and zero – based budgeting.

Ans. Incremental Budgeting:

Previous year's budget is used as basis and only adjustments are made to the budget. E.g. in a competitive market, cost budgets are reduced while sales budgets increased as compared to last year.

Departments only have to justify changes or increments for the coming year.

This type of budgeting doesn't allow for unforeseen events. But it is comparatively easy to prepare and is therefore less time – consuming.

Zero – Based Budgeting

Critical review of all activities each year is undertaken before a budget is prepared i.e. departments are required to justify the entire budget each year.

It is very time consuming as collection and analysis of detailed data is required.

Changing situations can be reflected in very different budget levels each year.

A questioning attitude is developed which helps reduce all unnecessary costs, eliminate inefficient practices and resource allocation is improved.

Q.2. Explain the difference between fixed & flexible budgets. Which of the two provides a better basis for variance analysis?

Ans. Fixed Budgeting is based on the assumption that the level of output remains at the predicted or budgeted level. So in case of an increase or fall in output, there would be a variance is the difference between budgeted and actual figures.

E.g. Budgeted outputs as 2000 units and actual output is 1500 units while sales revenue budgeted is \$100000 but actual is \$90000. In case of fixed budgeting this variance of \$10000 is adverse because sales revenue is lower than budget and this would reduce profits. However, this ignores the fact that output has fallen by 25%.

Flexible Budgeting on the other hand sets new budgets depending on the actual output level achieved which adjusts the figures according to a rise or fall in output levels.

E.g. In the above example to reflect the decrease in actual output, a new flexible budget is produced. According to this the sales revenue should be \$75000. Now we look at the variance which is \$15000 favourable as the actual revenue is greater than budgeted according to actual output produced.

Flexible budgets are more motivating for lower and middle management as they would be held responsible for adverse variances just because output has fallen. Flexible budgets give a more realistic target.

It is the flexible budgets which provide a better basis for variance analysis as they highlight the change in efficiency and not just in output like fixed budgets. It is the flexible budgets which give a more valid and accurate variance which helps decide the true productivity of labour and capital and allow performance to be seen as weaknesses of each department to be identified.