

Management Accountancy

Unit 8 Budgeting for Profit Planning

Structure

- Concept and Features of Budget
- Objectives, Advantages, Limitation of Budgeting
- Demand of Effective Budgeting
- Length of the Budget Period
- Budgeting and Management
- Zero Based Budgeting
- Advantages of Zero-Based Budgeting
- Limitations of Zero-Based Budgeting

After the completion of this unit, you should be able to:

- Concept and Features of Budget
- Describe Objectives, Advantages, and Limitation of Budgeting
- Understand Length of the Budget Period
- Enumerate Budgeting and Management
- Understand Concept of Zero Based Budgeting
- Explain Advantages and Limitations of Zero Based Budgeting

8.1 Introduction

The modern world of business abounds with competition, risk and a great deal of uncertainty. Despite the various problems and complexities, numbers of managerial methods and techniques have been developed in accordance with time and situation in order to conduct the firm successfully. Among them budgeting is the most widely used device for managerial control.

Budgeting is not a new concept. It has been in use for a very long time. Everybody is familiar with budget. Knowingly or unknowingly people make plans for their revenue and expenses. Some people do their planning entirely in their heads and express it orally. Other puts it in written form. For example, a house wife prepares 'family budget' every month and endeavours to keep the actual expenditure within the budget. It is also a preliminary concept of budget.

In the same way, every business undertakes to budget its expenditures for utilising the available funds more judiciously. The budget acts as a tool of planning in the business. The management of every business will prepare a budget related to different resources, e.g., material, labour, production and various expenditure. By preparing these different budgets, the management of business will be able to co-ordinate and control every activity of business.

8.2 Concept of Budget

Proper planning is indispensable to achieve the goal of maximum profit. For the implementation of such a plan, budget is regarded as the most effective device. A budget is effectively used for control purpose. It is a qualitative expression of a plan of action prepared in advance for the period to which it relates. In the simple word, budget is a statement showing the planned income and expenditure for a future period prepared in terms of money or quantity or both.

Budget can be defined as “a pre-determined statement of management policy during a given period which provides a standard for comparison with the results actually achieved”. Thus, budget denotes a planning for the future. It is a formal business plan for some future period. A budget is both a ‘plan’ as well as a "Control Tool". Budget is to be referred as a plan because it is a planning for future operation. Similarly, budget can be taken as a basis for subsequent evaluation of performance and can be referred as a control tool.

Budget is defined as “the quantitative and financial interpretation of the future plan of operation”, and as the “overall financial plan for future activities”. It is a plan for the utilization and co-ordination of various resources available in an organisation.

8.3 Features of Budget

The essential features of budget are under:

- A budget may be expressed in terms of quantity or money or both.
- It is related to a defined period in future.
- It pertains to a policy which is to be executed during budget period.
- Some specific objectives are to be achieved through the establishment of budgets.
- It serves as a basis for performance evaluation and control analysis.

8.4 Objectives of Budgeting

The main objectives of budget or budgeting are :

- To fix the targets and express them in monetary or quantitative terms.
- To state the firm's expectations or goals in clear and formal terms to avoid confusion.
- To communicate expectations to all concerned departments of the firm.
- To determine the policies for achieving the objectives or targets.
- To co-ordinate the activities and efforts among different departments.
- To properly guide the execution of works of different departments and set the standard of works.
- To control the performance of different departments in such a way that the use of resources is maximised.
- To measure the efficiency of different departments and supply information on the basis of which the necessary corrective action can be taken.

8.5 Advantages of Budgeting

The budgeting has the following advantages :

- Budgeting helps the activities of all departments of the business co-ordinate.
- Budgeting develops a sense of responsibility among the employees and assist in assignment of responsibility.
- A budget assists management to attain the given goals.

- It helps to maintain control over the production system. Therefore, it increases production efficiency and reduces waste.
- It contributes in the set up of the standard costing which can act a complimentary to budgeting.
- Budgeting provides management with insignificant knowledge to undertake the remedial action.
- Budgeting compels management to make an early and timely study of its problems and prepare for changing condition.
- With the use of budget, 'Cost consciousness' develops among the staff. Subsequently, the loss decreases and work-efficiency increases among them.
- With the installation of budgeting system, employees of the organisation become conscious of the needs to conserve business resources.
- While preparing budget, opinion is sought form all sections of employees. Their participation in the preparation and execution of budget increases morale among them, which in turn contributes maximum to the output.
- Budgeting helps in determining the policies of the organisation.
- Budgeting acts as a control tool for administration.
- Maximisation of profit through careful planning and control is possible with the help of budgeting.
- Budget serves as a medium of written communication. It ensures better understanding and harmonious relation between top management, managers and workers.
- The amount of capital needed for the budget period can be easily determined and properly managed with the help of budgeting.

8.6 Limitation of Budgeting

For running an enterprise systematically, budgeting is regarded as the most significant system. It has got so many advantages, which have already been listed above. However, the system suffers from certain limitations. Management must keep them in mind while using this system.

Following are the limitations of budgeting system :

1. Based on Estimate

Budget is an estimate about future. The success or failure of a budget depends upon the accuracy of estimate. Absolute accuracy is not possible in this world, although many statistical techniques are available. Hence, the user of budget must keep in view that budget is based on estimate.

2. Danger of Rigidity

Budgeting is an estimation and quantitative expression of all relevant data. So there can be the tendency to attach some sorts of rigidity for finality to them. But rigidness makes it useless. For usefulness, it must be revised with the changing circumstances.

3. Execution is not Automatic

The budget should be properly implemented for improving the management of an enterprise. For the success of budgeting system, it is essential to be understood by all the related persons inside the enterprise. Each executive must feel the sense of responsibility and should make efforts to attain the budgeted goals. Departmental heads should seriously think that it is their individual

responsibility to fulfil the target set up in their departmental budget. The success of a budgeting system totally depends upon the efficient management and administration.

4. Tool of Management

Budgeting is not a substitute for management. It is simply a management tool. It is totally wrong to think that the introduction of budgeting system is sufficient alone to ensure success and guarantee for budgeted goals.

5. Expensive Technique

The system involves cost in terms of money, time and energy. Normally, it is so costly that small concern cannot afford it. Even for a large concern it is suggested that there should be some correlation between the cost of operating a budget system and benefits derived from it. The system should be adopted only when benefits exceed the cost.

6. Morale of the Employees

Budget targets are sometimes considered as pressure tactics which lowers the morals of the employees. Therefore, unrealistic target should not be set and used as a pressure tactic.

8.7 Demand of Effective Budgeting

Effective budgeting improves efficiency, careful planning and the provision of information/data for management are required for effective budgeting. An effective budgeting demands the following conditions:

- The participation of both management and workers.
- Coordination and cooperation between management and workers.
- Sound accounting system.
- That new trends and inefficiencies are detected at an early stage of the planning/control process.
- The delegation of duties/authority, this will mean that job specifications will have to be clear and unambiguous.
- Control by responsibility
- A sound evaluation system for comparing/reporting on budget and actual results.
- The motivation to the work force.
- Good clear communications.
- Corrective action to made by management to remedy adverse situations.

8.8 Length of the Budget Period

A budget period is the length of time for which a budget is prepared and remains operative. No definite indication can be given as to what should be the period for which the budgets for a particular industry or business will be established. This would vary from industry to industry and even within the same industry or business.

The budget period depends upon the following:

- The types of budget, i.e., sales, production, capital expenditure, cash etc.
- General economic situation and the growth and stability of the product market.
- Nature of demand for the products of the undertakings.
- Length of the trade cycle of business (seasonal products)

- Production cycle, i.e., the start to finish period required for manufacture of the various products.
- Timing of the availability of finances.
- Extent of control over the operations.
- Probability of changes in products or product mix.

8.9 Budgeting and Management

Budgeting is a management technique. Management needs to set objectives and formulate policy. The budgets provide targets that reflect the objectives, and the policy. This is the means by which those targets should be achieved. Management must see that the targets are set fair, reasonable and attainable. To produce effective budgets managers must do the following:

- Secure the cooperation and participation of employees, e.g., supervisors, foremen.
- Communicate clearly and indicate acceptance of the budget.
- Possess negotiation/relationship skills and be able to cope with behavioural problems.
- Delegate the authority and responsibility for budgets to subordinates.
- Plan well in advance of the forthcoming budget period and the budget preparation process, e.g., timetables for meetings, etc. The aim is to ensure that the budget is ready to be implemented before the start of the new budget period.
- The appropriate meetings are required to held for review the previous budget and discuss future budget.
- Appoint a person to act as budget controller.
- Set up an effective monitoring and reporting system to compare budgeted with actual results at frequent intervals.
- Be prepared to take action to put right something, which is going wrong, as indicated by the feedback from comparative statements/reports.

8.10 Zero-based Budgeting

Zero-based budgeting (ZBB) is the latest technique of budgeting. The conventional budgeting is framed on the basis of previous budget. But ZBB is an approach to making with the base zero. It does not have any reference to the past and actual happening. Instead, the budget starts at 'Zero' base (scratch or clean state). ZBB refers to a 'nil budget'.

The concept and technique of ZBB was developed by Peter A Pyhrr of Texas Instrument of USA. It was first used in USA by Jimmy Carter, former President of America when he was the Governor of Georgia. Later it became popular and used also as a management tool. According to Peter A Pyhrr ZBB is "a planning budgeting process which requires each manager to justify his entire budget request in detail from scratch (hence Zero Base) and shifts the burden of proof to each manager to justify why he should spend any money at all activities, be analysed in 'decision packages' which are evaluated by systematic analysis and ranked in order of importance".

ZBB can be also termed as an "expenditure control devise", where each departmental head has to justify the requirement of funds for each and every type of expenditures and prepare the budget without any reference to the past budget or performances. In simple word ZBB can be defined as operating, planning and budgeting processes, which require each head of department to justify his entire budget request in detail from zero-base.

On the basis of above definition it can be stated that:

- ZBB begins at ground zero.
- It creates without using historical budgets as a baseline.
- Every cost area has to evaluate.
- It eliminates unnecessary activities.
- It justifies account for all components of the budget.
- ZBB also determine what activities should be performed and how to be performed.
- It rolls out comprehensive planning and execution process.
- It communicates clear plans, roles and responsibilities.

8.11 Advantages of ZBB

ZBB has the following advantages:

- ZBB improves the planning and control activities in the organization by relating cost and benefit.
- It adds psychological impetus to employers to avoid wasteful expenditure.
- This approach increases the communication and co-ordination within the organisation about certain decision.
- Inefficient and redundant activity is eliminated and duplicate activities are easily identified.
- The technique can be used for the introduction and implementation of the system of 'Management by Activities'
- It facilitates better control and maintenance of operating efficiency in the organisation.
- It develops skills and impersonal relationship for managers at all level.
- It is useful more for service department where it can be difficult to identify output.
- It leads to increased staff involvement which may lead to improved motivation and greater interest in the job.

8.12 Limitations of ZBB

The following are the main limitations of ZBB:

- ZBB requires properly trained managerial personnel to do the required job.
- It is very time consuming and a large number of paper works are needed.
- Manager develop fear feel threatened by ZBB and therefore may oppose new idea and changes.
- It is not suitable for all the activities in an organisation.
- ZBB is indifferent as to whether total budget is increasing or decreasing.
- Administration and communication of ZBB process may became critical problems as more managers become involved in ZBB.

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