SUBJECT: STRATEGIC COST ANALYSIS

Module 4: Budgeting and Control

19 Budgetary Control: Concepts of Budget and Budgetary Control

1. Concept of a Budget

A budget is a financial and quantitative statement prepared and approved prior to a defined period. It outlines the specific policies, target milestones, revenue goals, and resource allocations that management intends to execute during that future timeframe to achieve organizational objectives.

Core Characteristics: A budget is always calculated *prior* to execution; it focuses on a definite, specified future period; and it states planned goals in both monetary terms (rupees) and physical attributes (units, hours, headcount).

2. Concept of Budgetary Control

Budgetary Control represents a continuous management framework that uses budgets as a comprehensive strategy to plan, coordinate, execute, and audit business operations. It establishes a rolling cycle of corporate accountability by continuously matching live operational execution against predetermined budgetary baselines.

The Budgetary Control Cycle

A robust budgetary control system operates as a closed-loop system across four sequential phases:

1. Target Establishment	2. Execution Tracking	3. Variance Diagnosis	4. Remedial Action
Formulating clear, quantified departmental functional budgets (Sales, Production, Cash) aligned with macro strategic goals.	Continuously measuring and logging live, out-of-pocket operational cost data and revenue returns as they occur.	Systematically comparing actual performance logs against budget baselines to calculate and analyze variances.	Enforcing immediate corrective interventions to eliminate operational inefficiencies, or adjusting the budget if assumptions alter.

Strategic Advantages of Budgetary Control

- **Objective-Oriented Direction:** Shifts corporate behavior from defensive, day-to-day reactions to proactive, goal-driven execution.
- **Cross-Functional Coordination:** Eliminates departmental isolation. It ensures that the procurement team, production plant, and sales unit operate in perfect harmony (e.g., the production plan is locked to match sales demand forecasting).
- **Management by Exception (MBE):** Minimizes executive time waste. The system automatically highlights significant performance deviations (variances), allowing leadership to focus their analytical attention strictly on problem areas.

20 Types of Budgets, Fixed and Flexible and Cash Budgets

Organizations deploy varied budgeting frameworks customized by functional responsibility, time horizons, and structural capacity flexibility.

1. Classification by Function (Functional Budgets)

- **Sales Budget:** The primary foundational blueprint of the entire corporate budgeting system. It forecasts expected sales volume and revenue value across products, territories, and time frames. All other functional budgets (Production, Materials, Labor) are dependent on the sales forecast.
- **Production Budget:** Quantifies the total volume of finished products that must be manufactured to satisfy sales demand while maintaining target closing stock margins.
- **Master Budget:** A comprehensive summary budget that integrates all independent functional blueprints into a single unified corporate plan. It incorporates the budgeted Profit and Loss Account and the budgeted Balance Sheet.

2. Classification by Capacity Flexibility

- **Fixed Budget:** Formulated under the assumption that a single, specific volume of activity or capacity level will be achieved. It remains structurally static and unchanged regardless of actual output swings. It is effective only in highly predictable industries where market demand stays uniform.
- **Flexible Budget:** A dynamic budget built across multiple activity scales (e.g., 60%, 80%, 100% plant utilization). It categorizes expenses into fixed, variable, and semi-variable elements, automatically recalculating valid cost targets to match the volume of execution actually achieved.

3. Cash Budget

A **Cash Budget** is a detailed forecast of an organization's expected cash inflows and cash outflows over specified chronological intervals. It acts as the ultimate liquidity control tool, ensuring the enterprise maintains solvent working capital balances to satisfy liabilities while identifying future cash surpluses or deficits in advance.

21 Preparation and Interpretation of Cash, Flexible and Fixed Budget

This section provides standard structural layouts, practical application problems, and step-by-step solutions to master budget compilation and interpretation.

I. The Flexible Budgeting Framework

To compile an accurate flexible budget, a cost manager must separate semi-variable costs into fixed and variable elements using the High-Low Method, then scale variable costs linearly to match actual output capacity levels.

Practical Problem 1 (Flexible Budget): A manufacturing enterprise operates at 50% capacity, producing 5,000 units with the following cost structure:

• Direct Materials: ₹20 per unit | Direct Labor: ₹10 per unit

• Factory Overheads: ₹50,000 (40% Fixed, 60% Variable)

Prepare a Flexible Budget to interpret cost behaviors at 60% capacity (6,000 units) and 80% capacity (8,000 units).

Solution: Flexible Budget Compilation Sheet

Cost Components	50% Capacity (5,000 Units)	60% Capacity (6,000 Units)	80% Capacity (8,000 Units)
Direct Materials (₹20/unit)	1,00,000	1,20,000	1,60,000
Direct Labor (₹10/unit)	50,000	60,000	80,000

Cost Components	50% Capacity (5,000 Units)	60% Capacity (6,000 Units)	80% Capacity (8,000 Units)
PRIME COST TOTAL	**1,50,000**	**1,80,000**	**2,40,000**
Factory Overheads - Fixed Component (Stays Static)	20,000	20,000	20,000
Factory Overheads - Variable Component (₹6/unit)	30,000	36,000	48,000
TOTAL WORKS BUDGET	**2,00,000**	**2,36,000**	**3,08,000**

Interpretation: As capacity steps up from 50% to 80%, the total Works Cost rises from ₹2,00,000 to ₹3,08,000. However, the average cost per unit drops from ₹40 to ₹38.50 because fixed overheads are spread across a larger volume of production units.

II. The Cash Budgeting Framework

Cash budgets trace the timing of physical cash movements rather than accounting accruals. It excludes non-cash journal entries like depreciation or bad debt reserves.

Practical Problem 2 (Cash Budget): Compile a Cash Budget for a trading firm for the months of May and June using the following historical and projected operational data:

- Opening Cash Balance on May 1st: ₹30,000
- Projected Cash Sales: May = ₹60,000 | June = ₹80,000
- Projected Cash Purchases: May = ₹40,000 | June = ₹50,000
- Wages to be paid: May = ₹10,000 | June = ₹12,000

Solution: Cash Budget Compilation Sheet

Cash Flow Particulars	May (₹)	June (₹)
Opening Cash Balance (A)	**30,000**	**40,000**

Cash Flow Particulars	May (₹)	June (₹)
Cash Receipts (Inflows):		
• Cash Sales Revenue	60,000	80,000
TOTAL CASH AVAILABLE (B = A + Receipts)	**90,000**	**1,20,000**
Cash Payments (Outflows):		
• Cash Purchases Outlays	40,000	50,000
• Wage Settlements	10,000	12,000
TOTAL OPERATIONAL PAYMENTS (C)	**50,000**	**62,000**
CLOSING CASH BALANCE (D = B – C)	**40,000**	**58,000**

Interpretation: The closing cash balance of May (₹40,000) automatically shifts to become the opening cash base for June, illustrating a healthy, liquid working capital trajectory capable of supporting expansion runs.

22 Zero Base Budgeting

Concept and Meaning of Zero-Base Budgeting (ZBB)

Zero-Base Budgeting is an advanced, revolutionary budgeting methodology developed by **Peter Pyhrr** at Texas Instruments during the 1970s. It stands in direct contrast to traditional *Incremental Budgeting* (which simply takes the previous period's budget as a given base and adjusts it upward or downward for inflation or minor expansions).

Under ZBB, the historical budget base is completely rejected. Every single manager must justify their entire budget request from scratch—starting from a **"Zero Base"**—proving conclusively that every operational activity and expense item is necessary and cost-effective.

The Structural Process of Zero-Base Budgeting

Implementing a ZBB framework requires executing four strict analytical stages:

- **1. Identification of Decision Units:** Isolating distinct, independent cost-generating functional segments within the organizational hierarchy that are capable of meaningful cost-benefit evaluations (e.g., a regional marketing team or a specialized corporate training wing).
- **2. Construction of Decision Packages:** Documenting an operational blueprint for every decision unit. Each package details the specific goals of the unit, the resource requirements, alternative execution paths, and the negative consequences if the unit is defunded.
- **3. Evaluation and Ranking:** Central management evaluates all submitted decision packages against available corporate funds, ranking them in order of priority based on strategic cost-benefit analysis.
- **4. Resource Allocation:** Corporate funds are allocated to decision packages according to their final priority rank until the budget limit is reached, defunding low-priority or redundant packages entirely.

Strategic Advantages and Operational Challenges

Strategic Advantages of ZBB	Operational Challenges of ZBB
• **Eliminates Bloat:** Systematically removes historical inefficiencies, redundant activities, and corporate waste. • **Optimizes Resource Allocation:** Directs corporate capital toward high-return projects rather than departments with historical inertia. • **Improves Cost Awareness:** Forces functional managers to analyze their operations critically and justify expenses.	• **Time-Consuming & Complex:** Requires enormous volumes of clerical work and data collection every budgeting cycle. • **Direct Managerial Resistance:** Facing pushback from functional heads whose un-justified funding lines are reduced or cut. • **Quantification Friction:** Highly complex to evaluate non-financial qualitative departments like HR or legal affairs.

End of Module 4 • Budgeting and Control