

Budgeting for Business Organizations – Types | Functions | Control

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Budgeting for business organizations

is the process of creating a financial plan that outlines the expected income, expenditures, and resource allocation for a specific period, typically a fiscal year. It helps businesses plan, coordinate, and control their activities by setting financial goals, forecasting revenue, and determining the resources required to meet those goals. Budgeting also involves monitoring actual performance against the planned budget to identify variances, allowing businesses to make necessary adjustments. It ensures efficient use of resources, aids decision-making, and aligns the organization's financial activities with its strategic objectives.

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1. Introduction

The term 'Budget' is commonly used in every household. Though we do not always sit down to write our monthly budgets, everyone keeps some numbers in mind regarding how he/she wants to plan his/her monthly family expenses. Suppose a person is thinking about buying a new house, throwing a party, or going on a trip. In such situations, the first question that usually comes to mind is: What is the budget? Thus, we often tend to relate the term 'budget' with limitations on spending. However, budgeting is a lot more than that. Even as students we are constantly involved in budgeting when we are trying to make the best use of our limited time, money and energy to score well, finance our education and complete our degrees on time. Governments also prepare budgets for every financial year and businesses also need to indulge in budgeting to get the best out of available resources. So, in this article, we will be discussing budgeting for business organizations in detail. Let us start with a simple question: What is a budget?

2. Budget – Meaning and Definition

A **budget** is a plan for a specified future period of time expressed in financial and non-financial terms. In financial terms, a budget expresses management's expectations about income, expenditure and cash flows. The non-financial aspects of the budget include the number of units to be produced, the number of employees to be hired, the quantity of raw material to be purchased etc. Let us take a look at some definitions of budget.

According to the Chartered Institute of Management Accountants (CIMA), “Budget is a quantitative expression of a plan for a defined period of time. It may include planned sales volumes and revenues; resource quantities, costs and expenses; assets, liabilities and cash flows.”¹

According to Brown and Howard, “A budget is a predetermined statement of management policy during a given period which provides a standard for comparison with the results actually achieved.”²

In the words of Horngren, Datar and Rajan, “A budget is the quantitative expression of a proposed plan of action by management for a specified period and an aid to coordinate what needs to be done to implement that plan. It generally includes both financial and non-financial aspects of the plan, and it serves as a blueprint for the company to follow in an upcoming period.”³

The above definitions highlight the role of budgets in planning, controlling and coordinating business activities. The entire process of preparing a budget is called budgeting.

Organizations prepare different types of budgets. A master budget is a consolidated summary of various functional budgets (such as sales budget, production budget, direct materials usage budget, direct labour budget, administration cost budget, etc.) and comprises budgeted financial statements. The various types of budgets will be discussed in detail later in the chapter.

2.1 Budget Period

The budget period is the time period for which a budget is prepared and used. It can vary from one year (or less) to several years, depending on the objective for creating a budget and the uncertainties involved. In most organizations, the budget period used is one year. The master budget is usually prepared on an annual basis, which is often sub-divided into months and quarters. It is important to note that the budget period for capital expenditure may differ from that of other budgets because it outlines estimated expenditure on long-term assets and therefore typically covers several years.

Traditionally, organizations have been observed to prepare a yearly budget once a year. The budget for the coming year is usually prepared towards the end of the current year (maybe during the last four or five months). The yearly budget can be divided into quarterly budgets or monthly budgets as per requirement. This approach has often been criticised because managers are involved in planning only once a year when budgets are being prepared. In fact, managers should constantly look ahead and plan for the future. Therefore, an alternative approach called continuous or rolling budgeting ensures that budgeting remains a continuous process. A rolling budget is a budget that is constantly updated by adding a further accounting period (a month or a quarter) when the earliest accounting period has expired⁴. To elaborate, let us suppose that a company has prepared a budget for the period April 2020 to March 2021. If the traditional approach to budgeting is adopted, the next year's budget (*i.e.*, April 2021 to March 2022) will be prepared towards the end

of the current budget period. But under rolling budgeting, during the first quarter of the current budget period (*i.e.*, April-June 2020) the company will prepare a new quarterly budget for April-June 2021. So, when the April-June 2020 quarter comes to an end, the company still has the budget for the next one year. In other words, the quarter that just ended is dropped and a new quarter is added in the future. So, now the company has a budget for the period July 2020 to June 2021. Similarly, during the July-September 2020 quarter, the company will prepare a budget for the quarter July-September 2021 and this process continues. As the year unfolds, the quarterly budgets may also be reviewed and updated in light of changing conditions. Thus, the process of rolling budgeting continuously forces managers to think about the next 12 months and also ensures that a yearly budget is available to the company all the time.

2.2 Budgeting and Forecasting

Both budgets and forecasts relate to the future but a budget is not the same thing as a forecast. A budget is a plan for a specified future period of time. It clearly expresses management's expectations and involves a commitment to achieve the targets laid down in the budgets. A forecast, on the other hand, is a statement of what is considered likely to happen in the future in relation to a particular situation but does not involve any commitment regarding the realization of those forecasts. We often come across weather forecasts on news channels. Thus, forecasts may relate to economic as well as non-economic activities. But budgets usually relate to the economic activities of individuals and organizations.

We cannot, however, ignore the relationship between budgets and forecasts. Forecasts are very helpful in the process of preparing budgets. For example: If an expert forecasts an increased level of competition in the coming years, then this information is valuable for preparing the sales budget and marketing budget for the upcoming budget period. To combat a higher level of competition, management may decide to spend more on advertising and sales promotion which can help them maintain or increase their customer base and achieve the targets laid down in the sales budget. In fact, the sales budget will also be influenced by this forecast. Management may decide to reduce the selling price to survive the competition.

2.3 Budgetary Control

Budgetary control is a system of exercising control over a firm's activities through the preparation of budgets. According to the Chartered Institute of Management Accountants (CIMA)⁵, "Master budget, devolved to responsibility centres, allows continuous monitoring of actual results versus budget, either to secure by individual action the budget objectives or to provide a basis for budget revision." This highlights how budgets can be used to monitor business activities. In the words of Brown and Howard⁶, "Budgetary control is a system of controlling costs which includes the preparation of budgets, coordinating the departments and establishing responsibilities, comparing actual performance with that budgeted and acting upon results to achieve maximum profitability." We can outline the steps involved in the process of budgetary control as follows:

- Budgets are prepared for each department of the organisation.
- Actual performance is compared with the budgeted performance to determine variation in performance.
- The variations are analyzed to know the reasons (controllable or uncontrollable) behind the difference in performance and to fix responsibility for deviations in performance.
- Corrective actions are taken, wherever required and budgets may be revised in the light of changed circumstances.

3. Objectives or Functions of Budgets

Some important functions or objectives of budgets are as follows:

1. **Planning:** Budgets are detailed short-term plans that help in implementing long-term. It specifies what the targets are, how the targets should be achieved, and who is responsible for what. Budgeting necessitates looking into the future, anticipating the changes in future conditions, and responding to those changes. Thus, it helps managers plan by providing a course of action for the future and minimizing the chances of encountering situations requiring quick temporary solutions or stopgap arrangements.
2. **Coordination:** Budgets help in coordinating the activities of various departments so that everyone works towards reaching the goals of the organization. Budgeting requires that the manager of a particular department should analyze the relationships between the activities of his/her department with those of others to identify and correct conflicts if any. For example, the production budget should be prepared in coordination with the sales budget. If the production department manufactures goods that the sales department is not able to sell then it will lead to undesirable inventories. Similarly, the sales department should not accept orders for goods that the production department cannot manufacture. In the same way, there should be proper coordination between the purchase budget and production budget so that adequate raw material is available for the production process. Therefore, budgets should be prepared in such a way that activities of various parts of the organization remain in balance.
3. **Communication:** Communication is important to ensure that everyone knows and understands the goals. Only then everyone can be expected to support those goals and coordinate their efforts to achieve them. Budgeting is a formal way of communicating the expectations of top management to lower levels so that all the employees have a clear understanding of their role in reaching the goals. Budget preparation involves participation from all levels and a lot of information is communicated to the various levels in the process. Top management communicates goals to the lower levels and lower-level managers provide feedback on those goals. Thus, the entire process of budgeting as well as the final budgets prepared communicate to the employees the level of performance expected from them.
4. **Motivation:** A budget can serve as a useful tool for motivating employees to perform in line with organizational goals. For this, it is important to ensure active participation from all levels in the

process of preparing budgets. Employees happily accept a budget if they have actively participated in budgeting and it helps them in managing their departments. Otherwise, budgets may seem like a threat and can lead to resistance and conflicts among employees.

5. **Control:** An important function of budgets is to serve as a control device. A budget clearly expresses the level of performance expected from The actual performance of employees is compared with the budgeted performance to find deviations if any. It is important to analyze the deviations to figure out the reasons for those deviations. Corrective actions can be taken, wherever required. The control process allows managers to operate a system of 'management by exception' which means that managers should focus only on significant deviations from planned outcomes.
6. **Performance Evaluation:** For evaluating the actual performance of employees, budgeted performance is generally considered to be a better criterion than past performance. This is because current conditions, duly considered while budgeting for the current year, might be different from the conditions prevailing in the past. Thus, the performance of an employee can be evaluated by measuring the extent to which he/she has succeeded in reaching the targets indicated in the budget. If the actual performance of an employee meets or exceeds the budgeted performance then it may be called satisfactory. In some organizations, bonuses and promotions also depend on an employee's ability to adhere to the budget.

4. Prerequisites for Successful Budgeting

A successful budgeting system has certain prerequisites as discussed below:

1. **Support of Top Management:** A budgetary system must be supported by top management in order to be This is because top management is required to devote the necessary resources to budget preparation and implementation. If top management is positive and confident about the whole budgeting process then everyone else in the organization also feels convinced and confident.
2. **Clear and Realistic Goals:** Budgeting can prove effective only if the efforts of all the employees are directed towards a common Therefore, the goals to be achieved must be clearly specified. Also, the goals should be realistic and reasonable, i.e., neither too high nor too low. If goals are too high then they seem impossible to achieve and have a negative impact on employee morale. At the same time, a low level of goals does not provide any motivation to employees to work hard.
3. **Active Participation:** Employees throughout the organization should actively participate in budgeting. Further, participation should be meaningful, i.e., inputs of employees should have some real effect on budgets. Active participation in the process has a positive impact on employee commitment and motivation. As a result, they make every effort to ensure that budgets are effectively prepared and implemented.
4. **Well-Defined Authority and Responsibility:** A sound organizational structure that clearly defines the authority and responsibility of every manager is essential for successful If there is no clear-cut assignment of authority and responsibility then a particular manager cannot

be held accountable for a particular activity.

5. **Efficient and Suitable Accounting System:** Effective budgeting requires an efficient accounting system because historical data derived from the accounting system forms the basis for several estimates required for budget. Further, the accounting system should be structured in a way that facilitates the planning and control process. A system of responsibility accounting that clearly identifies the areas of responsibility helps in successful budgeting. The creation of responsibility centres facilitates the implementation of budgets, budgetary control and performance evaluation.
6. **Budget Education:** It is extremely significant to educate all the employees about the utility, nature and methods of budgeting. For successful budgeting, everyone needs to understand how to interpret budgets and how their performance is evaluated using Proper budget education through seminars, discussions, executive development programs, etc. makes everyone more committed and involved in the whole process of budgeting.

5. Budget Administration

For small businesses, budgeting can be a simple exercise spanning a few days or weeks and all the tasks connected with budgeting may be handled by a budget officer or an accountant. But for large organizations, it's a lengthy time-consuming process that takes months to complete. It is important to have proper administrative procedures in place for budgeting to be smooth and effective. Also, required staff support should be provided to managers in the process of preparing budgets.

Budget Committee: In large organizations, often a budget committee is set up for budget administration. A budget committee usually consists of executives representing the main departments of the business such as production, sales and finance. The main functions of this committee are:

1. To issue general instructions for preparing
2. To provide technical advice for budget
3. To review individual
4. To suggest budget
5. To reconcile conflicting
6. To coordinate the various budget-related
7. To approve budgets.
8. To formulate the master budget after approval of various functional
9. To analyze the comparison of budgeted figures with actual figures and suggest required corrective actions.

Budget Officer: A budget director or budget officer is appointed as the overall in charge of the budget committee. The budget officer is a staff expert and should adopt an unbiased approach to handling budget matters.

Accounting Staff: It provides the required assistance in budget preparation in the form of disseminating important instructions related to budgeting, providing historical information that helps managers in forecasting and preparing budgets, and ensuring timely submission of budgets by managers.

Budget Manual: A budget manual is a written set of guidelines and information for budget preparation. It is usually prepared by the accountant and is circulated to all those who are involved in budgeting. It provides valuable information related to:

1. Objectives
2. Procedures involved
3. Sample budget forms
4. Submission deadlines
5. Budget assumptions (For example, assumptions regarding inflation and interest rates)

Any other information deemed important for the budget program may be included in the budget manual. Thus, it serves as a rule book and a useful reference source for all those involved in budget preparation.

6. The Process of Budgeting

Budgeting is a very significant exercise for most organizations and therefore a systematic and formally established procedure is usually adopted for budget preparation. Budget centres are identified before starting the process. A budget centre is a section, part or department of an organization for which a separate budget is prepared. For instance, the sales department, production and purchase departments are examples of budget centres for which the sales budget, production budget and purchase budget are prepared. If the required administrative support is in place and the budget period is decided, an organization can start the budget-setting process which involves the following important steps:

- **Communicate budget guidelines:** The first step involves communicating budget guidelines to those responsible for preparing budgets. To start with it is important to know the strategic plans and their impact on the coming budget period. The impact of strategic plans on the forthcoming budget in the form of changes in sales mix or expansion of business activities should be communicated to the relevant managers. Further, clear guidelines should be provided regarding the expected rate of inflation, changes in market demand, technological changes, etc.
- **Determine the principal budget factor:** The principal budget factor (also known as the key factor or limiting factor) is the factor that restricts the activities or performance of an organisation for a given period. Following are some examples of limiting factors that may impact budgeting:

Sales (Limited market demand)
Materials (Limited supply of raw material)
Labour (Shortage of trained labour force)
Plant (Limited plant capacity due to lack of capital)

The key factor may be different for different budget periods due to changes in circumstances. It is important to identify this factor at the earliest possible stage because it serves as the starting point for budget preparation. For instance, if sales demand is the key factor, then the sales budget is prepared first and other budgets will follow the sales budget.

- **Prepare the budget for the area of the principal budget factor:** The key factor determines the overall level of activity of the organization and therefore the first budget is prepared for the area related to the key. In most of the organizations, the limiting factor is probably the sales demand. Therefore, quite often sales budget is the first and the most important budget in the budget-setting process.
- **Prepare initial budget proposal for all other areas:** Initial budget proposals relating to all other areas are prepared by the relevant managers. It is important to ensure that these budgets complement the budget prepared for the area of the key. The various budget items can be determined on the basis of past data as well as expected changes in future conditions. There are two alternative approaches to individual budget preparation: the top-down approach and bottom-up approach. The top-down approach is a non-participatory approach where budget targets for each area are determined by senior management without any involvement of sub-ordinates. The bottom-up approach, on the other hand, is participative budgeting which allows individuals working at all levels to participate in the budget-setting process. In this approach, generally, budget targets are developed at the lower levels of management and are further refined at higher levels. This is usually considered to be a better approach as employees are more likely to accept the budgets and work towards achieving them.
- **Negotiate budgets:** Under the bottom-up approach, budgets are developed at lower levels and submitted to superiors for approval. As budgets pass from lower levels to higher levels, negotiation is involved at every level of authority. It is important to ensure that attempts are not made to get such budgets approved which are easily attainable. At the same time, unattainable budget targets should not be imposed on. The bargaining process should ultimately lead to mutually agreeable budgets.
- **Review and coordination of budgets:** The budget committee reviews all the budgets to ensure that they adhere to the guidelines and. Any lack of coordination or imbalances should be identified. For instance, if the production manager targets to produce a quantity that the sales department cannot sell then it reflects a lack of coordination between the production and sales manager. Such inconsistencies should be communicated to the relevant managers and the required alterations should be done.
- **Final approval and communication of budgets:** Once the individual budgets are in place, they are summarized into a master budget. The budget committee usually prepares the

master budget and gives the final The formally approved budgets are then communicated to the relevant managers.

- **Monitor actual performance:** Budgeting does not end with the approval of budgets. Actual performance is compared with budgeted performance at regular intervals to ensure that everything is proceeding as per If there are any deviations in performance then reasons are identified and corrective actions are taken. If deviations arise due to actual conditions being different from those expected then budgets may have to be revised. Thus, budget setting is not a one-off exercise; rather it is a continuous process.

7. Functional Budgets

Functional budgets are the budgets that focus on the various functions of the business such as sales, production, administration, etc. These budgets are prepared for each function of the business and form an integral part of the master budget. There can be various types of functional budgets depending on the nature and size of business operations. Some of the important ones are as follows:

1. Sales Budget
2. Production Budget
3. Direct Materials Usage Budget
4. Direct Materials Purchase Budget
5. Direct Labour Budget
6. Factory Overhead Budget
7. Production Cost Budget
8. Selling and Distribution Cost Budget
9. Administration Cost Budget
10. Capital Expenditure Budget
11. Cash Budget

7.1 Sales Budget

A sales budget presents forecasts of expected sales for each product in units as well as rupees. In other words, it shows what the business expects to sell to its customers and the price that it plans to charge during the budget period (see Exhibit 1). The budgeted sales can be analyzed under various classifications such as products, territories, customers, salesmen etc. The sales budget is one of the most important budgets, especially when sales is the limiting factor because several other budgets are contingent on forecasted sales. For instance, budgeted numbers for production cost, selling and distribution expenses, cash to be received from customers etc. depend on the sales budget. So, if the sales budget is incorrect, several other budgets will be affected. Also, the sales budget is one of the most difficult budgets to be prepared because the sales forecast depends on several controllable as well as uncontrollable factors. Controllable factors like the selling price to be charged, advertising expenditure and sales effort can be managed by the firm

relatively easily. But changes in uncontrollable factors like customer tastes and preferences, competitors' reactions and economic conditions are difficult to predict. Several aids are available for forecasting sales, among which are⁷:

1. **Reports by salesmen:** Salesmen are often expected to submit reports regarding what they expect to sell in their areas during the budget period. These estimates are given a lot of importance in determining budgeted sales because salesmen are in direct touch with the market and have a good understanding of prevailing conditions.
2. **Analysis of past sales:** Statistical tools can be used to analyze past sales which can help in identifying trends to date and any seasonal or cyclical. This analysis can suggest future trends and provide an estimate of what the business can expect to sell.
3. **Market analysis:** Market analysts can provide a lot of crucial information relating to customer preferences, fashion trends, competitor's activities and several other market-related factors that impact sales.
4. **Company conditions:** Any changes in corporate policy or methods that impact sales budget should be. For example, the introduction of new products, new advertising campaigns and the setting up of new channels of distribution.
5. **Business conditions:** Any changes in economic and political conditions should also be considered. For example, if the government changes indirect tax regulations, then sales of several products might be impacted.

Exhibit 1: Sales Budget For the Year Ending December

PRODUCT	Sales (in units)	Selling price (in ?)	Total Sales Revenue (in ?)
	—	—	—
A			
B	—	—	
			—
	.	.	.
.			
.	.	.	
			.
	.	.	.

7.2 Production Budget

A production budget shows the number of units to be produced during the budget period to meet sales demand and closing inventory requirements. The formula that forms the basis for the production budget is:

$$\text{Budgeted Production (in units)} = \text{Budgeted Sales (in units)} + \text{Desired Closing Inventory (in units)} - \text{Opening Inventory (in units)}$$

Thus, budgeted production or the number of units to be produced during the budget period is based on the sales budget. However, it is important to note that the production budget cannot be finalized without ensuring that sufficient production facilities are available. If the available production facilities fail to meet the requirement, then either the sales budget can be revised or efforts can be made to build additional production capacity by purchasing new machinery and introducing double shifts and overtime. If the available production capacity exceeds the budgeted production, then management can plan how to use the excess capacity. The production budget is the responsibility of the production manager. It is expressed in terms of quantities only (as depicted in Exhibit 2) and does not indicate how much it will cost to produce those units. This budget provides the information needed for preparing the various production cost budgets: direct materials usage budget, direct labour budget and factory overhead budget.

Exhibit 2: Production Budget (in Units) For the Year Ending December

	Department 1	Department 2
Details		
	(Product A)	
	—	(Product B)
	—	—
Budgeted sales*		

Add: Desired closing inventory	—	
	—	—
	—	—
Total units needed for sales and inventory		
Less: Opening inventory	—	
	—	—
	—	
Units to be produced		—

*Number of units to be sold as per sales budget

7.3 Direct Materials Usage Budget

The direct materials usage budget provides details of the estimated quantity and cost of raw materials (see exhibit 3) to be used for producing the level of output indicated by the production budget. Usage of direct materials depends on the input-output relationship and its estimates are given by the engineering department. If different departments are involved in the production process, then departmental managers are responsible for preparing the direct materials usage budget. This budget provides inputs for preparing the direct materials purchase budget and production cost budget.

Exhibit 3: Direct Materials Usage Budget For the Year Ending December

Type of Material	Department 1			Department 2			Total (iii) (iv)+(vi)
	Quantity of direct material (i) (in units)*	Price per unit (ii) (in ?)	Cost of direct material (iii) (i)×(ii))=(iii)	Quantity of direct material (iv) (in units)*	Price per unit (v) (in ?)	Cost of direct material (vi) (iv)×(v))=(vi)	
Material X	—	—	—	—	—	—	—
Material Y	—	—	—	—	—	—	—
Total			—			—	—

*Units to be produced of a particular product (as per production budget) × Direct material units required per unit of production

7.4 Direct Materials Purchase Budget

This budget shows the quantity and cost of direct materials to be purchased during the budget period. Direct material to be purchased should be sufficient to meet the production and material inventory requirements. The format of this budget is a little similar to that of the production budget and it is based on the following formula:

$$\begin{array}{rclcl}
 \text{Direct} & = & \text{Expected} & + & \text{Desired Closing} & - \\
 \text{Material} & & \text{Usage of} & & \text{Inventory of} & \\
 \text{Purchases} & & \text{Direct} & & \text{Direct Materials} & \\
 \text{(in units)} & & \text{Materials (in} & & \text{(in units)} & \text{Opening} \\
 & & \text{units)} & & & \text{Inventory of} \\
 & & & & & \text{Direct} \\
 & & & & & \text{Materials (in} \\
 & & & & & \text{units)}
 \end{array}$$

The above formula gives the number of units of raw material to be purchased which can be multiplied by the planned purchase price to estimate the direct materials purchase cost as shown in Exhibit 4. The purchase manager is usually responsible for preparing the direct materials purchase budget.

Exhibit 4: Direct Materials Purchase Budget For the Year Ending December

Details	Material X	Material Y
Expected usage of direct materials (in units)*	—	—
Add: Desired closing inventory of direct materials (in units)	—	—
Total units needed for production and inventories	—	—
Less: Opening inventory of direct materials (in units)	—	—
Total units to be purchased	—	—
Purchase price per unit (in ?)	—	—
Total purchase cost of direct materials (in ?)	—	—

*as per the direct materials usage budget

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