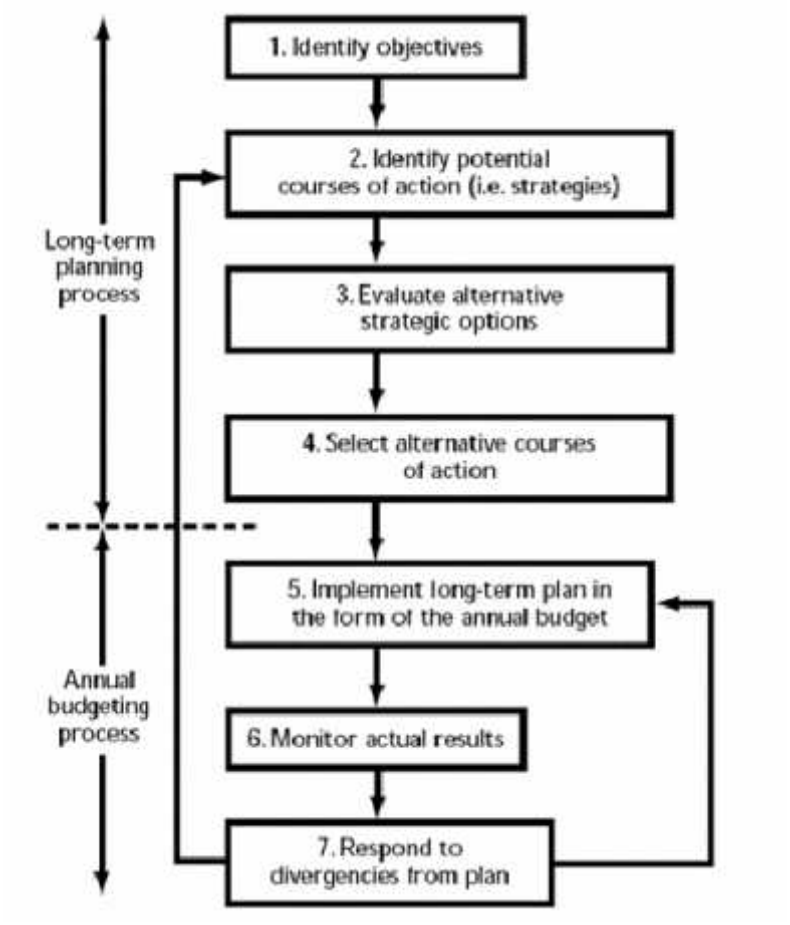
UNIT IV – BUDGETING

Overview of the planning process

- Identify the objectives of the organization.
- Identify potential strategies.
- Evaluate alternative strategic options.
- Select course of action.
- Implement the long-term plan in the form of the annual budget.
- Monitor actual results.
- Respond to divergencies from plan.



Why do we produce budgets?

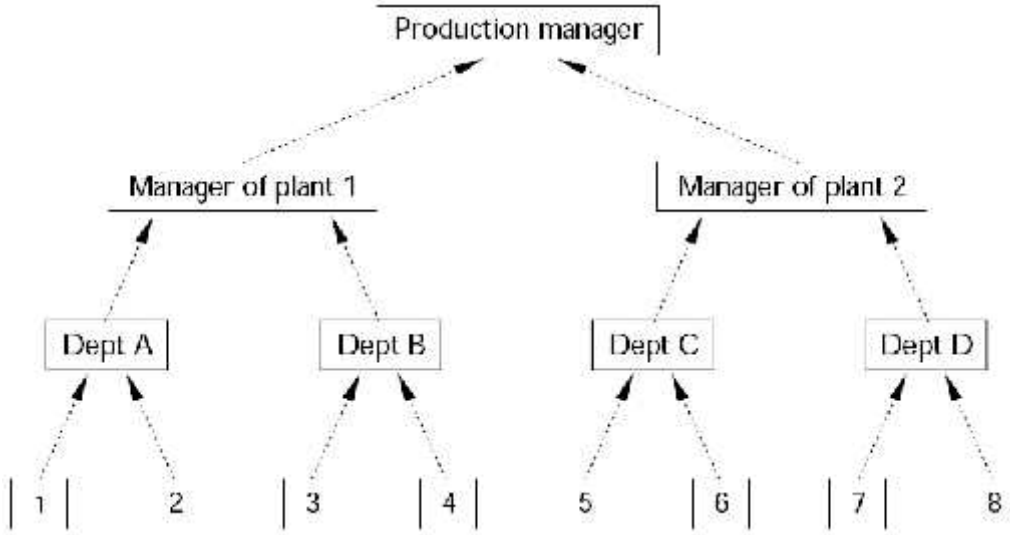
- To aid the ***planning*** of actual operations:
  - by forcing managers to consider how conditions might change and what steps should be taken now.
  - by encouraging managers to consider problems before they arise.
- To ***co-ordinate*** the activities of the organization:
  - by compelling managers to examine relationships between their own operation and those of other departments.
- To ***communicate*** plans to various responsibility centre managers:

  - everyone in the organization should have a clear understanding of the part they are expected to play in achieving the annual budget.
  - by ensuring appropriate individuals are made accountable for implementing the budget.
- To ***motivate*** managers to strive to achieve the budget goals:
  - by focusing on participation
  - by providing a challenge/target.
- To ***control*** activities:
  - by comparison of actual with budget (attention directing/management by exception).
- To ***evaluate*** the performance of managers:
  - by providing a means of informing managers of how well they are performing in meeting targets they have previously set.

Stages in the budgeting process

- Communicate details of budget policy and guidelines to those people responsible for preparing the budget.
- Determine the factor that restricts output.
- Preparation of the sales budget.
- Initial preparation of budgets.
- Negotiation of budgets with higher management.
- Co-ordination and review of budgets.
- Final acceptance of budgets.
- Ongoing review of the budgets.

Budgets moving up the organisation hierarchy



The Integrated Process

- Primary budget drives all others
- Planned increase in **sales** affects
  - production
  - purchases

- labour
- cost of overheads
- financing/cash

What Is Budget? – Definition

In business, a budget may be defined as a formal expression of the expected income and expenditure for a definite future period.

According to J. Fred Meston: "A budget is the expression of a firm's plan in financial form for a period of time in the future."

According to J.L. Brown and L.R. Howard: "A budget is a pre-determined statement of management policy during a given period which provides a standard comparison with the result actually achieved." George R. Terry has defined budget as "an estimate of future needs arranged according to an orderly basis, covering some or all the activities of an enterprise for a definite period of time."

The Institute of Cost and Management Accountants has defined a budget as "a financial and/or quantitative statement, prepared prior to a defined period of time, of the policy to be pursued during that period for the purpose of attaining a given objective."

Explanation

The three main functions of management are planning, operating and control. Planning relates to the future, operating to the present and control to the past. For assisting the management in the functions of planning and control, two techniques are applied viz., budgetary control and standard costing systems. Budgetary control system is usually operated with a system of standard costing since both systems are inter-related but it should be remembered that these two systems are not inter-dependent.

In the context of the budgetary control system, we should now discuss the main term "Budget". The term Budget has been derived from the French word 'Bougette' which means a leather bag from which the Minister of the Government would take out his proposals regarding the expenditure and revenue of the Government during the coming financial period. Now-a-days, the budget is not restricted to Government affairs only. It covers domestic, business and institutional affairs as well.

Features Of A Budget

A careful study of the above discussion brings out the following features of a budget:

(i). A budget is a plan. A budget is an expression of the plan of the operations of an enterprise. The operations of an enterprise are affected by a number of factors-both external (such as general business conditions, government policy and size and composition of the population) and internal (such as manufacturing processes, promotional programs). The budget covers both external and internal factors and expresses partly what the management expects to happen and partly what the management intends to happen.

(ii). It is comprehensive. A budget is comprehensive which means that it covers the activities and operations of all the segments or divisions of an organization. Budgets are prepared for each segment or division of an organization and all these are integrated into a Master Budget.

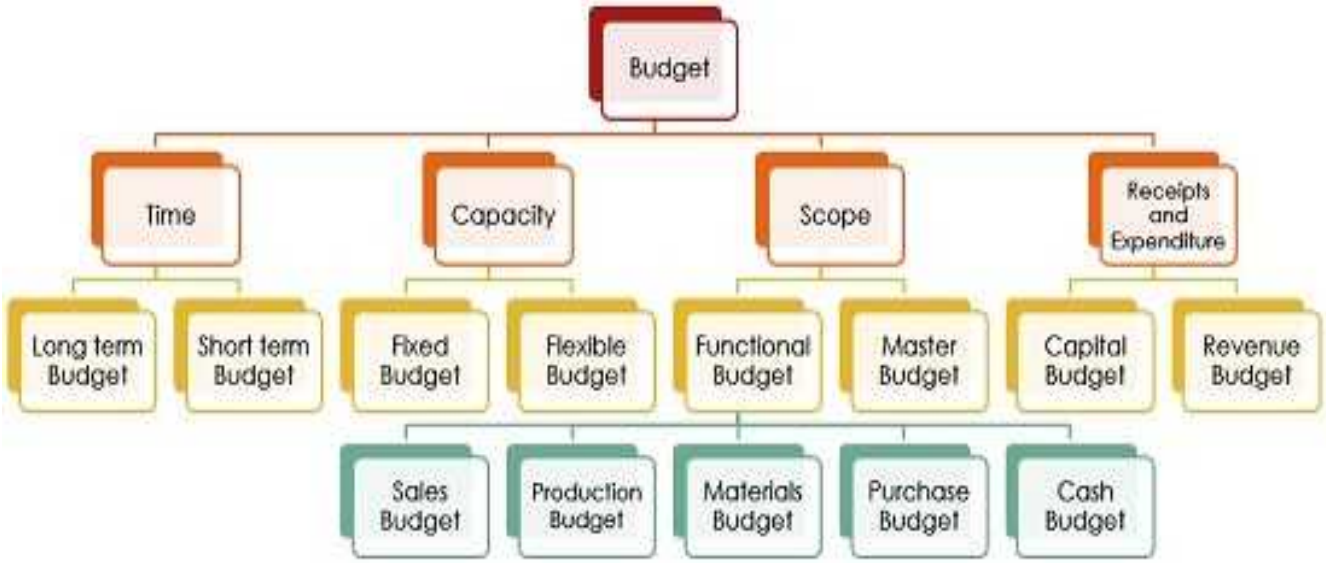
(iii). It provides for a co-ordinated plan: The budgets are prepared for the various segments or division of an organization after considering the conditions and problems of each segment. The budgets for all the components are prepared in harmony with one another.

(iv). It is prepared in advance. A budget is prepared in advance and denotes the future course of action. Thus, a budget is forward-looking in approach.
(v). It relates to a specific future period. A budget always relates to a specified future period. A budget becomes meaningless if it is not related to a time horizon. Thus, budgeted output, sales, profits, etc., are planned to be achieved in a pre-determined time framework.
(vi). it is a plan for Operations and Resources. A budget is a mechanism to plan for the operations and resources of an organization. The operations are expressed in terms of revenues and expenses. The plan also covers the planning of the resources of the organization. Resources refer to the various assets and the sources of capital available to finance these operations.
(vii). It is expressed in Financial and/or Quantitative Terms. A budget is always expressed in financial or monetary terms. It is due to the fact that the monetary unit is a common denominator. The various activities and operations of a business concern may be expressed in different units e.g., Material Budget is expressed in terms of weight, Labour budget in terms of labor hours, Sales budget in terms of sales territories. But for the purpose of integration into a plan, all these budgets have to be expressed in terms of some comparable unit of measurement. This comparable unit is provided by monetary unit.
(viii). It provides a yardstick for the comparison of actual performance. A budget provides for the comparison of actual achievements with the specified goals. This comparison is of utmost importance for exercising effective control over the business operations since it helps in fixing the responsibility for variances between actual performance and budgeted performance.

Benefits of Budgeting

- Requires all levels of management to plan ahead.
- Provides definite objectives for evaluating performance at each level of responsibility.
- Creates an early warning system for potential problems.
- Facilities coordination of activities within the organization.
- Results in greater management awareness of entity's overall operation.
- Motivates personnel throughout the organization to meet planned objectives.

Classification of Budgets



Types of budget

Based on time

Long-term Budget: The budget designed by the management for a long-term, i.e. three to ten years is called as long-term budget.

Short-term Budget: As the name suggests, the budget which is prepared for a period ranging from 1 to 2 years, is called short-term budget.

Based on Capacity

Fixed Budget: The budget created for a fixed activity level, i.e. the budget remains constant regardless of the level of activity, is called as fixed budget.

Fixed Budget is prepared for a fixed or standard volume of activity. They do not change with the change in the volume of activity. These budgets are prepared well in advance. They are not helpful for making comparison.

According to I.C.M.A. "a fixed budget is a budget designed to remain unchanged irrespective of the level of activity actually attained".

Fixed budget is normally prepared when activities can fairly be forecast with reasonable certainty.

Flexible Budget: The budget which changes with the change in the level of activity is a flexible budget. It identifies the fixed cost, semi-variable cost and variable cost, to show the expected results at different volumes.

The I.C.M.A. defines flexible budget as, "a budget which is designed to change in accordance with the level of activity attained". Basically, the idea of a flexible budget is that there shall be some standard of expenditure for varying levels of output.

Flexible budgetary control has been developed with the objective of changing the budget figures progressively to correspond to the actual output. The preparation of budgets necessitates the analysis of all overheads into fixed, variable and semi- variable costs.

The I.C.M.A. defines the above costs as follows:

Fixed cost: a cost which tends to be unaffected by variation in volume of output.

Variable cost: a cost that tends to vary directly with the volume of output.

Semi-variable: a cost which partly fixed and partly variable.

Based on Scope

Functional Budget: The budget which is concerned with the business functions is called as functional budget. It can be further classified as:

Sales Budget: Sales budget is used to determine the quantity of anticipated sales and the expected selling price per unit.

Production Budget: It is prepared to indicate the production for the specified period and is expressed in the units of outputs produced.

Materials Budget: The budget prepared to show the quantities of direct material and raw material required to manufacture the finished product.

Purchase Budget: Purchase budget is designed to estimate the quantity and value of different items to be bought at different points of time, considering the production schedule and inventory required.

Cash Budget: The budget highlights the cash needed by the business in a specified period, taking into account all the receipts and payments of the business.
The cash budget is a forecast of the cash position for a period and represents the cash receipts and payments and the estimated cash balance each month of the budget period. This budget is practically the nerve center of the whole budgetary control system since the most carefully prepared budgets are incapable of fulfillment if adequate cash is not available at the proper time. The main functions of this budget may be summarised as follows:

- It ensures that sufficient cash is available to meet the requirements of the organisation.
- It reveals any expected shortage of cash so as to enable the management to arrange for cash in time by means of bank overdraft or loan etc.
- It reveals any expected surplus of cash available for investment outside the business.
- This budget is prepared after all the functional budgets have been drawn up.

Cash Budget of a business concern can be prepared by Receipts and payments Method, Adjusted Profit and Loss Method and Balance Sheet Method. But the Receipts and Payments Method is the most popular method and is commonly used by business concerns. Under this method, cash budget is prepared just like a summarised cash book. For the purpose of preparing cash budget, all types of 'Cash Receipts' or 'Cash Inflows' (including opening balance of cash/bank) are to be estimated in a logical manner period-wise, keeping in view the past figures, existing trends and expected changes in future.

Apart from those discussed above, there are other functional budgets also, i.e. plant utilization budget, direct material usage budget, factory overhead budget, production cost budget, cost of goods sold budget, selling and distribution cost budget, administration expenses budget, etc.

Master Budget: Once all the functional budgets are created, then the financial officer will prepare a master budget. It is an integrated budget that reflects the estimated profit and loss and financial position using Budgeted Profit & Loss Account and Budgeted Balance Sheet of the concern.
The Master Budget is one that projects the activities of the business during the budget period. It commonly takes the form of budgeted Profit and Loss Account and Balance Sheet. It is prepared by the Budget Officer, and incorporates the details shown in the subsidiary budgets.
Master Budget that consolidates an organisation's overall plans for a shorter span of time is usually prepared on an annual basis. The Master Budget is an integrative tool that cuts across divisional boundaries to, coordinate the firm's diverse activities. A Master budget takes the macro view of the business enterprise and coordinates sales with production, raw materials, manpower, machinery and other resources.

Based on Receipts and Expenditure
Capital Budget: The budget takes into account the estimated capital receipts and expenditure of the business for a specified period.

Revenue Budget: The budget that covers all the revenue receipts and expenses of a particular financial year is a revenue budget.
A budget acts as a map for the future economic activities of the business, which are prepared as per the policies of the different organizational functions. It aims at making optimum utilisation of the capital and other resources of the organization.

An illustration of different types of Budget

Sales Budget

An estimate of expected sales for the budget period.

Hayes Company
Sales Budget
For the Year Ending December 31, 2002

	Quarter				
	1	2	3	4	Year
Expected unit sales	3,000	3,500	4,000	4,500	15,000
Unit selling price	x ₹60	x ₹60	x ₹60	x ₹60	x ₹60
Total sales	₹180,000	₹210,000	₹240,000	₹270,000	₹900,000

Hayes Company
Production Budget
For the Year Ending December 31, 2002

	Quarter				
	1	2	3	4	Year
Expected unit sales (sales budget)	3,000	3,500	4,000	4,500	
Add: Desired ending FG units[a]	700	800	900	1,000[b]	
Total required units	3,700	4,300	4,900	5,500	
Less: Beginning FG units	600[c]	700	800	900	
Required production units	3,100	3,600	4,100	4,600	15,400

[a]20% of next quarter's sales
[b]Expected 2003 first-quarter sales, 5000 units x 20%
[c]20% of estimated first-quarter 2002 sales units

Hayes Company
Direct Materials Budget
For the Year Ending December 31, 2002

	Quarter				
	1	2	3	4	Year
Units to be produced (Illustration 6-5)	3,100	3,600	4,100	4,600	
Direct materials per unit	x 2	x 2	x 2	x 2	
Total pounds needed for production	6,200	7,200	8,200	9,200	
Add: Desired ending Direct Materials	720	820	920	1,020	
Total materials required	6,920	8,020	9,120	10,220	
Less:Beginning Direct Materials	620	720	820	920	
Direct materials purchases	6,300	7,300	8,300	9,300	
Cost per pound	x ₹4	x ₹4	x ₹4	x ₹4	
Total cost of DM purchases	₹25,200	₹29,200	₹33,200	₹37,200	₹124,800

Hayes Company
Direct Labor Budget
For the Year Ending December 31, 2002

	1	2	3	4	Year
Units to be produced (from production budget III 6-5)	3,100	3,600	4,100	4,600	
Direct labor time (hours) per unit	x 2	x 2	x 2	x 2	
Total required direct labor hours	6,200	7,200	8,200	9,200	
Direct labor cost per hour	x ₹10	x ₹10	x ₹10	x ₹10	
Total direct labor cost	₹62,000	₹72,000	₹82,000	₹92,000	₹308,000

Manufacturing Overhead Budget

- **Shows the expected manufacturing overhead costs for the budget period.**
- **Distinguishes between fixed and variable overhead costs.**
- **The fixed cost amounts are assumed, and Hayes expects the following variable costs per direct labor hour:**
  - **indirect materials: ₹1.00**
  - **indirect labor: ₹1.40**
  - **utilities: ₹0.40**
  - **maintenance: ₹0.20**

Hayes Company
Manufacturing Budget
For the Year Ending December 31, 2002

	Quarter				
	1	2	3	4	Year
Variable Costs					
Indirect materials (₹1.00 per DLH)	₹ 6,200	₹ 7,200	₹ 8,200	₹ 9,200	₹ 30,800
Indirect labor (₹1.40 per DLH)	8,680	10,080	11,480	12,880	43,120
Utilities (₹ .40 per DLH)	2,480	2,880	3,280	3,680	12,320
Maintenance (₹.20 per DLH)	1,240	1,440	1,640	1,840	6,160
Total variable	18,600	21,600	24,600	27,600	92,400
Fixed costs					
Supervisory salaries	20,000	20,000	20,000	20,000	80,000
Depreciation	3,800	3,800	3,800	3,800	15,200
Property tax and insurance	9,000	9,000	9,000	9,000	36,000
Maintenance	5,700	5,700	5,700	5,700	22,800
Total fixed	38,500	38,500	38,500	38,500	154,000
Total manufacturing overhead	₹57,100	₹60,100	₹63,100	₹66,100	₹246,400
Direct Labor hours	6,200	7,200	8,200	9,200	30,800
Manufacturing overhead rate per direct labor hour (₹246,400 ÷ 30,800)					₹ 8.00

Selling and Administrative Expense Budget

- **Is a projection of anticipated operating expenses.**
- **Distinguishes between fixed and variable costs.**
- **Fixed cost amounts are assumed, and Hayes expects the following variable costs per unit sold (from sales budget):**
  - **sales commissions: ₹3.00**
  - **freight-out: ₹1.00**

Budgeted Income Statement

An estimate of the expected profitability of operations for the budget period.

Hayes Company
Selling & Administrative Budget
For the Year Ending December 31, 2002

	Quarter				
Variable Costs	1	2	3	4	Year
Sales commissions (₹3 per unit)	₹ 9,000	₹ 10,500	₹ 12,000	₹ 13,500	₹ 45,000
Freight-out (₹1 per unit)	3,000	3,500	4,000	4,500	15,000
Total variable	12,000	14,000	16,000	18,000	60,000
Fixed costs					
Advertising	5,000	5,000	5,000	5,000	20,000
Sales salaries	15,000	15,000	15,000	15,000	60,000
Office Salaries	7,500	7,500	7,500	7,500	30,000
Depreciation	1,000	1,000	1,000	1,000	4,000
Property taxes and insurance	1,500	1,500	1,500	1,500	6,000
Total fixed	30,000	30,000	30,000	30,000	120,000
Total selling and administrative expenses	₹42,000	₹44,000	₹46,000	₹48,000	₹180,000

Hayes Company
Budgeted Income Statement
For the Year Ending December 31, 2002

Sales (Illustration 6-3)	₹900,000
Cost of goods sold (15,000 x ₹44)	660,000
Gross profit	240,000
Selling & administrative expenses	180,000
Income from operations	60,000
Interest expense	100
Income before income taxes	59,900
Income tax expense	12,000
Net income	₹ 47,900

Financial Budgets Consist of:

- **Capital Expenditure Budget**
- **Cash Budget**
- **Budget Balance Sheet**

Cash Budget: A projection of anticipated cash flows.

Any Company Cash Budget	
Beginning cash balance	₹x,xxx
Add: Cash receipts (itemized)	x,xxx
Total cash available	x,xxx
Less: Cash disbursements (itemized)	x,xxx
Excess (deficiency) of available cash over cash disbursements	x,xxx
Financing	x,xxx
Ending cash balance	₹x,xxx

Budgeted Balance Sheet
A projection of financial position at the end of the budget period.

Hayes Company
Budgeted Balance Sheet
December 31, 2002

ASSETS

Cash		₹ 37,900
Accounts receivable		108,000
Finished goods inventory		44,000
Raw materials inventory		4,080
Buildings & Equipment	₹ 192,000	
Less: Accumulated Depreciation	48,000	144,000
Total assets		₹337,980

LIABILITIES AND STOCKHOLDERS' EQUITY

Accounts payable	₹ 18,600
Common stock	225,000
Retained earnings	94,380
Total liabilities and stockholders' equity	₹337,980

Management Functions

- Planning
- Directing and Motivating
- Controlling

Budgetary Control

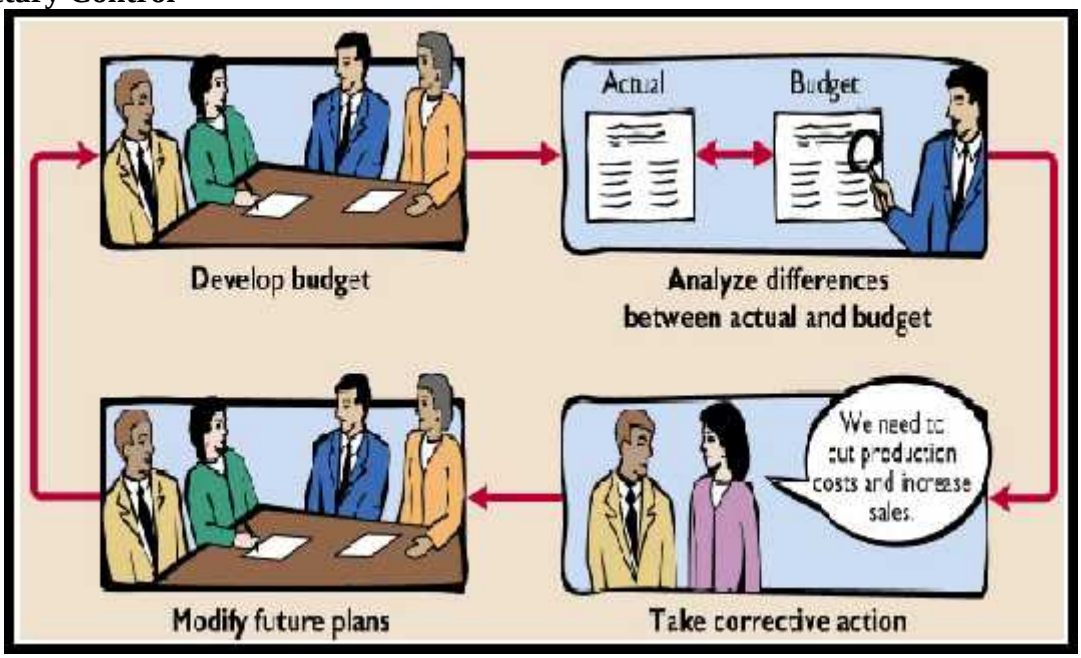
- One of the three main functions of management is to control.

- Budgets are useful in controlling operations.

Budgetary Control

- The use of budgets to control operations.
- Compare actual results with planned objectives.

Budgetary Control



Budgetary Control Reporting System

Name of Report	Frequency	Purpose	Primary Recipient(s)
Sales	Weekly	Determine whether sales goals are being met	Top management and sales manager
Labor	Weekly	Control direct and indirect labor costs	Vice president of production and production department managers
Scrap	Daily	Determine efficient use of materials	Production manager
Department Overhead costs	Monthly	Control overhead costs	Department manager
Selling expenses	Monthly	Control selling expenses	Sales manager
Income Statement	Monthly and quarterly	Determine whether income objectives are being met	Top manager

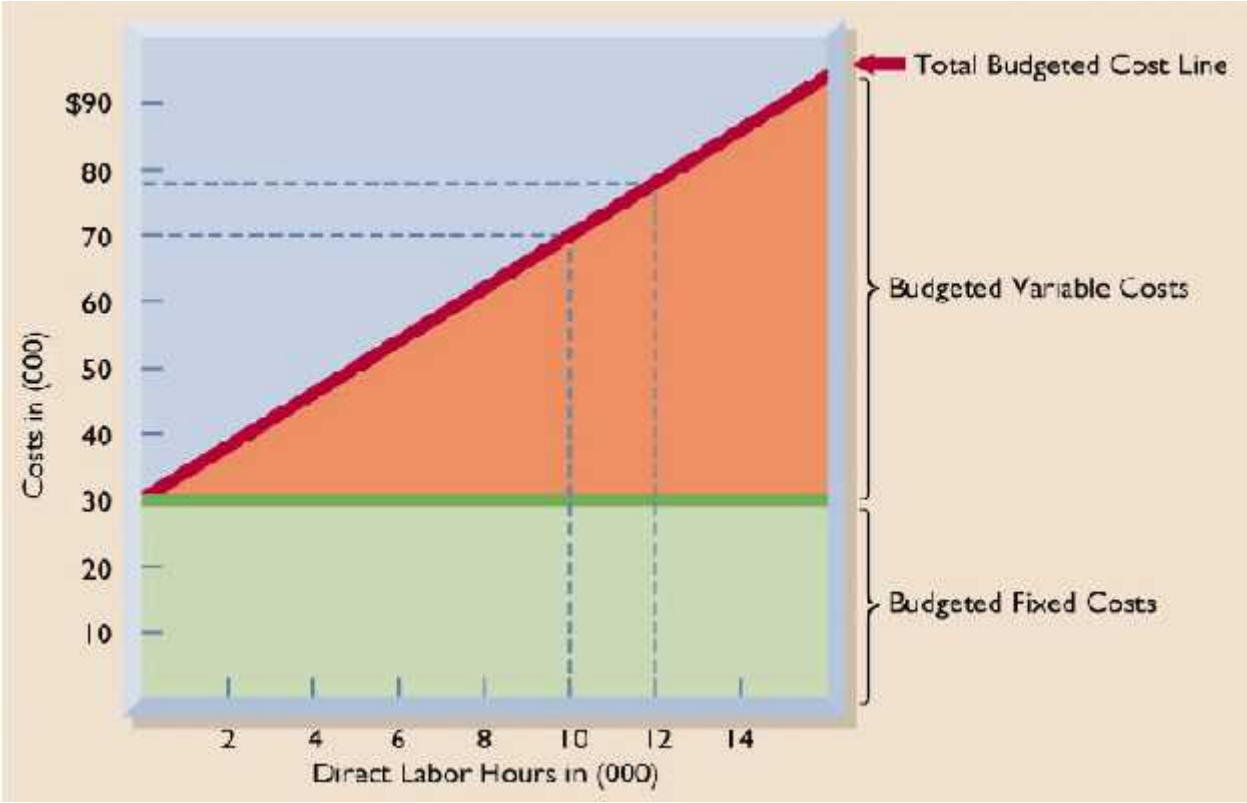
Barton Steel (Forging Department)
Manufacturing Overhead Budget (Fixed/Static)
For the Year Ended December 31, 2002

Budgeted Production in units (steel ingots)	10,000
Budgeted Costs	
Indirect materials	₹ 250,000
Indirect labor	260,000
Utilities	190,000
Depreciation	280,000
Property taxes	70,000
Supervision	50,000
	₹1,100,000

Flexible Budget

Activity level					
Direct labor hours	8,000	9,000	10,000	11,000	12,000
Variable costs					
Indirect materials (₹1.50)	₹12,000	₹13,500	₹15,000	₹16,500	₹18,000
Indirect labor (₹2.00)	16,000	18,000	20,000	22,000	24,000
Utilities (₹.50)	4,000	4,500	5,000	5,500	6,000
Total variable	32,000	36,000	40,000	44,000	48,000
Fixed costs					
Depreciation	15,000	15,000	15,000	15,000	15,000
Supervision	10,000	10,000	10,000	10,000	10,000
Property taxes	5,000	5,000	5,000	5,000	5,000
Total fixed	30,000	30,000	30,000	30,000	30,000
Total costs	₹62,000	₹66,000	₹70,000	₹74,000	₹78,000

Flexible Budget at 10,000 and 12,000 Levels



Zero Base Budgeting

Purpose of Zero-Base Budgeting

The Objective of Zero Based Budgeting is to "reset the clock" each year. The Traditional incremental budgeting assumes that there is a guaranteed budgetary base-the previous year' level of appropriations -and the only question is how much of an increment will be given. Zero Based Budgeting implies that managers need to build a budget from the ground up, building a case for their spending as if no baseline existed- to start at zero. Resources are not necessarily allocated in accordance with previous patterns and consequently each existing item of expenditure has to be annually re-justified.

Put differently, the purpose of ZBB is to reevaluate and reexamine all programs and expenditures for each budgeting cycle by analyzing workload and efficiency measures to determine priorities or alternative levels of funding for each program or expenditure. Through this system, each program is justified in its entirety each time a new budget is developed.

Historical development of ZBB

ZBB or some modified version of it, has been used in the private- and public -sectors for decades. The first known application of zero-base budgeting was by the U.S Department of

Agriculture in 1962. However, the general problem of incremental budgeting that zero-base budgeting attempts to solve has been recognized from a much earlier period.

Indeed, the major next application of ZBB in government has been tracked back to GOV. Jimmy Carter's use of it in Georgia in the early 1970s.

In the private sector, the major leap forward occurred with the development at Texas Instruments Inc. of a way to handle the mass of data. This involved the implementation of a "Decision Package" approach to prepare the 1970 budget for the Staff & Research Divisions.

Application of ZBB

The practical application of ZBB involves the use of the "Decision Package". All budgetary procedures involve an identification of organizational objectives. In the context of these objectives, ZBB involves three stages:

1. Identification of decision units.
2. Development of decision package.
3. Review and ranking of decision packages.

1) Identification of decision units

The existing organization structure identifies the units in the hierarchy for which budgets are prepared. These could responsibility centers, cost centers, profit centers, investment centers, program categories or program elements. This is the starting point for identifying decision units for ZBB. Decision units should have the following characteristics:

A specific manager should be clearly responsible for the operation of the program

- It must have well defined & measurable impacts
- It must have well defined & measurable objectives.
- After the identification of appropriate decision units, the next step is to prepare for each of these a document describes the objectives or purposes of the decision unit and the actions that could be taken to achieve them. Such document is called "Decision Package"

2) Development of Decision packages

Two types of decision package:

A. The mutually exclusive decision package; the purpose here is to identify for each decision unit the alternative ways of performing its functions so as to enable management to choose the best alternative. One such alternative will be to abolish the decision unit and not to perform it functions at all.

B. The incremental decision package; Here, each manager identifies different levels of effort (and associated costs) and their impact on the function. i.e. there will be a Minimum Level, below which it would be impossible to perform the function; a Base Level, which reflects the current level of activity; and Improvement Level, which shows the effect of increases over the current level.

3) Review and Ranking of decision Package

Once the decision packages have been prepared, they are ranked on an ordinal scale i.e 1st, 2nd, 3rd, etc.in order of priority. In situation where a "bottom-up" approach and due to large number of decision packages,the ranking process would take place at a number of levels.

How would you choose the decision units?

Answer: Suppose you are the chief executive of a local authority, and there are 5 departments under your responsibility and you ask the manager in charge of Educational Department to adopt the ZBB.

Using the educational service as an example, first the decision units could be at any of the following levels:

- the service level, with the whole of the education service being one decision unit, the whole of highway service being one decision units,& so on;
- the 'division of service' level, which for education would mean the whole of primary education being one decision unit, the whole of secondary education being one decision unit, & so on;
- the subdivision of service level, which would mean that each school would be one decision unit; or
- the school department level, with each department, such as history or physics, being one decision unit.

In connection with this, one scholarly writer stresses that: "Agencies should ensure that the basic decision units selected are not so low in the structure as to result in excessive paperwork and review. On the other hand, the units selected should not be so high as to mask important considerations and prevent meaningful review of the work being performed"

With regards to decision package, the intention is to identify alternative ways of performing the functions of a decision unit and to determine the effect of different levels of effort on each alternative. Some experts suggest that in practice "it is adequate first to select the best alternative from among the mutually exclusive decision packages, and then to use this as the basis for the incremental decision package analysis".

Strengths of ZBB

- ZBB unlike incremental traditional line item budget, it dose not assume that last year's allocation of resources is necessarily appropriate for the current year, all the functions of an organization are re-evaluated annually from a zero base. The systematic nature of such a fundamental review imposes a discipline on the organization which has produced in practice secondary advantages;
- It produces in a readily accessible form more and better management information. This in turn will improve the quality of management's decision.
- Another advantage that stems from this improved management information is that its production involves the participation of lower - level management in the budgetary process, and the smaller the decision units, the greater this involvement will become.
- Unexpected events that occur during the financial year can be more readily adjusted for. This is because the basic information for modifying goals has already been generated.
- If implemented well, ZBB can eliminate a sense of "entitlement" to cost increases.
- Improved discipline in developing budgets.
- More meaningful budget discussions during plan review sessions.

Weaknesses of ZBB

- ZBB vastly overestimates man's ability to calculate.
- In practice the effects of different levels of effort on each alternative mutually exclusive decision package are not considered, due to the short budgetary cycle and the need for expediency. But this might lead to a sub-optimal allocation of resources.

- By incorporating performance measures in the formation of decision packages, it forces managers to establish a preference for effectiveness, efficiency, or equity as they try to rank decision packages. This make the ranking process difficult.
- The use of cutoff point for packages is different in public agencies. As a result, when funds become tight, even in ZBB systems, each department is asked to make marginal reductions, rather than eliminate the lowest ranked programs.
- The implementation of a ZBB system requires a great deal of time on the part of agency staff, limiting their ability to perform other important functions.
- Attempts by agencies to manipulate priority listings by ranking popular items lower than items that would have little chance of funding.
- Established programs have political support and they will continue to receive their share of the budget regardless of any analysis produced.

Performance Budgeting

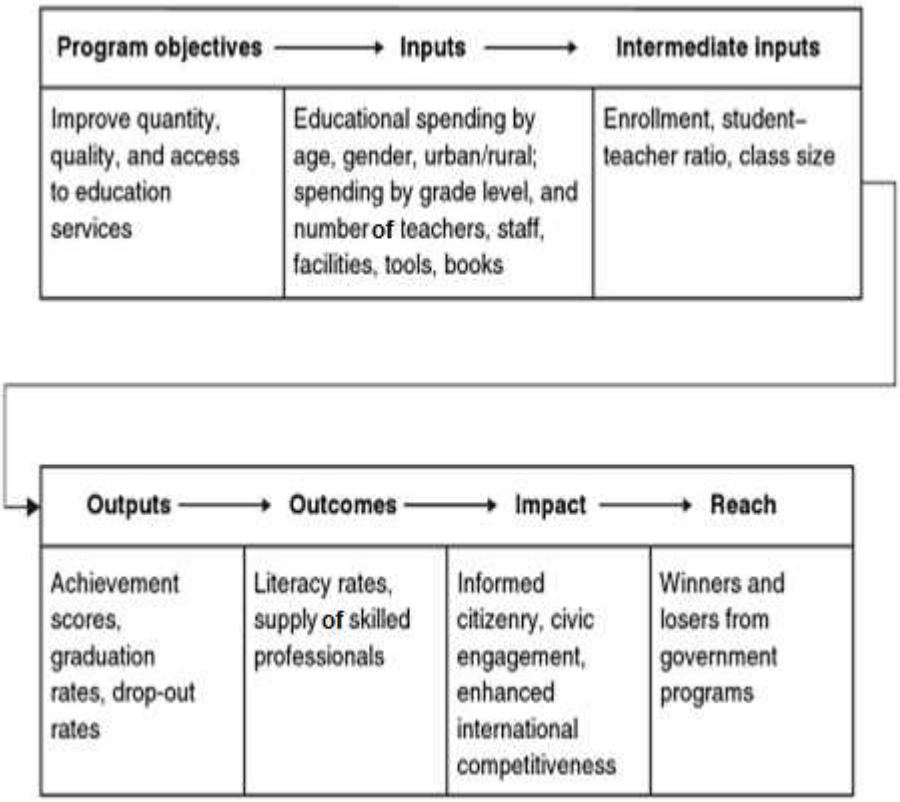
A budget contributes a lot in economic policy of any company. Budget is a financial plan and a list of all planned expenditures and profits. It is a chart for saving, borrowing and spending. Management theorists have explained budget as an important device that is used to relate planned resource consumption for a period of time (Mellett et al. 1993). A budget is a plan for the achievement of programs associated with objectives and goals within a specific time period, that include an estimate of resources compulsory and an estimate of resources available, usually compared with one or more past periods and represent future requirements. Budgeting is the organized way to assign resources and an important component of financial success. It is an activity to empower organization to perform stated goals and objectives (Briones, 1996).

Performance budgeting is a method of budgeting that provides the purpose and objectives for which funds are needed, costs of programs and related activities proposed to accomplish those objectives and outputs to be produced or services to be rendered under each program (Shah, 2007). Performance budgeting follows the validation that a relaxation of input controls and an increased flexibility enhances managers' performance as long as results are measured and managers are held responsible for their results (OECD 2005b). The major aim of performance budgeting is to improve the efficiency of public expenditure, by linking the funding of public sector organizations to the results they deliver. It adopts organized performance information (indicators, evaluations, program costings) to make this link. There is a good impact of performance budgeting on organizations in terms of improved prioritization of expenditure, and in improved service effectiveness.

Theoretical literature denotes that as compared to traditional budgeting, performance budgeting facilitates for more flexible use of economic resources and transforms focus from inputs to results. Performance budget focuses on the results to be accomplished. The performance budget, given its program structure, changes the focus of conversation from detailed line items to broader objectives and performance of public programs, and allows more conversant budgetary decision-making. Performance budget presents greater managerial suppleness by providing the program or department manager a fixed lump sum distribution that may be used for various needs in order to accomplish the agreed upon results in service delivery. Performance budgeting is more than introducing performance information into the budget process. Main characteristic of the new performance budgeting procedure is the identification that, if performance is the mater, the

objectives of the budget management system must be incorporated with overall responsibility, so that good budgetary performance is compensated, and poor performance is punished.

Performance Based Budgeting tries to resolve issues related to decision making problems. Performance may be judged by certain programs ability to attain objectives that contribute to a more abstract goal as calculated by that programs ability to use resources efficiently by linking inputs to outputs.



Factors in Performance Budgeting Reforms

There are numerous considerations for performance budgeting reforms.

1. **Budget Classification:** Performance budgeting modifies the focus on resource allocation from the objects of expenditure to public programs designed to serve strategic objectives of the government. Funds are allocated to various objectives (results) and spending agencies manage the lump sum allocation in seeking more cost-effective and innovative ways of achieving results, and central budget control focuses on the achievement of program goals by each agency rather than by the detailed line itemization of the agency's budget (Shah, 2007).
2. **Performance Measurement and Reporting:** A successful performance budgeting system depends greatly on consistent performance measurement and reporting. Since performance measurement and reporting do not directly influence budgetary allocations, the plan does not immediately incur financial risks for public managers and therefore serves as good efforts for the reform. The creation of a performance measurement and

reporting system provides a channel for public officials to reach agreement on program goals/objectives and, discuss and compromise on the selection of performance measures, to deal with questions and concerns, and to beat their doubts about performance budgeting.

Further, a performance budgeting system requires numerous measures that determine public program from a variety of lens such as inputs, output (quantity and quality of goods and services produced), efficiency (unit cost to produce outputs), service quality (measure of service such as timeliness, accessibility, courtesy, accuracy, and satisfaction), and outcomes (progress in achieving program objectives) (McGill 2001). Different measures gauge dissimilar features of budgeting practice. The use of various indicators instead of a single measure rests on unsure and distorted relationship between inputs, process, and results, an inherent feature of public programs. In other words, the outcomes or service quality associated with a government program cannot be inferred just by reporting its outputs. Therefore, one must supervise the complete results based chain in order to recognize and successfully manage government programs.

3. **Output-focused Performance Management Paradigm:** Performance management is a requirement for the achievement of performance budgeting. Governments that do not manage for results do not budget for results. Performance budgeting cannot succeed unless it is developed into an overall managerial scheme for performance. According to Donald Kettl (2000), there are two sets of performance management strategies. One strategy depends on market-like arrangements and the other relies on managerial norms and competence. Both strategies offer the flexibility public managers need to improve performance. The critical differences between them are the dependence on incentives and competitive spirit in the first and good will and trust in the latter. The two approaches take dissimilar viewpoint on how to reward public employees.
4. **Informed Budgetary Decision-Making:** Performance Budgeting cannot be expected to be a mechanistic, rational system that replaces the political process of making resource choices in complex environment of competing demands. Instead, it brings more economic values in budgetary decision making and fosters an information-based consideration process that assigns significant weight to performance information, rewards good performance with managerial flexibility and other incentives. Impractical expectation for performance budgeting, by creating a direct and explicit linkage between resource allocation and budget results explains why many scholars are pessimistic about Performance Budgeting practices because there is almost never any link between performance and resource allocation in actual life.

Reason to select performance budgeting: Since last two decades, there are major reforms in Performance Budgeting. PB reform can improve communication between budget actors, improve public management in terms of effectiveness, help more informed budgetary decision-making, and accomplish high transparency and accountability. Current Performance Budgeting initiatives are less flourishing in terms of changing appropriation levels (Kristensen, et al. 2002). Four important factors of Performance budgeting that are observed from recent research experience;

1. Enhanced communication between budget actors and with citizens: Performance budgeting make clear program goals/objectives and recognize performance targets, which presents companies and employees good expectation for their performance. It helps

public managers converse more successfully about their activities to the executives, governmental members, and the public. A performance budget, with explanation of each government program, performance measures, and budget information, is available to ordinary populace and therefore facilitates public managers to circulate information about their programs to the public, and to obtain public understanding and support of their activities.

2. Improved management in government agencies: Performance budgeting reform can assist program managers identify organizational goals/achievement, observe program performance, have better acquaintance about problems with program structure and operation, plan for the future, improve internal control, and communicating program results.
3. More informed budgetary decision-making: Performance budgeting may not downsize and change the political budgeting process, but it positively adds value to deliberations as performance information is taken into account when the level of funding is decided. With correct information, politicians can implement techniques for improvements and can better understand the issues involved. Performance information has active role in resource allocation in the following instances: justify reallocation of resources given performance information; change the focus of discussion from line items to broader objectives and performance of agencies and programs; influence decisions about proposed new programs and on funding increases or decreases to programs; and provide benchmarks useful to legislators in decision making.
4. Higher transparency and accountability: The budget document is good mechanism of precision and accountability, to the legislative body and the public. When analysing traditional budgets, they fail to deliver important information regarding the implementation of the government plans. Performance budget categorizes resources by programs and also presents performance indicators. The performance budgeting system looks for results-based accountability holding managers accountable for the objective they have to accomplish.

Process of doing performance budgeting

There are four categories of performance budgeting:

1. Performance reporting budgeting: It provides performance information as part of the budget documentation but budgetary players do not use it for resource allocation.
2. Performance informed budgeting: This is a type of budgeting process that takes program performance in to account but uses the information only as a minor factor in decision making.
3. Performance based budgeting: It means that performance information has vital role in resource allocation but does not assess the amount of resource allocated.
4. Performance determined budgeting: In this budgeting procedure, allocation of resources directly and explicitly related to units of performance.

Drawbacks of performance budget: A shortcoming of a performance budget occurs if the budget document is unchanging for the whole financial year. A government or non-profits agency might use a fixed deed to systematize business activities with a specific funding level. A fixed document does not offer for changing budget allocations mid-year in response to transformed conditions. In a performance budget, an organization starts at the baseline and

creates a budget request for each department. When all of the departments and activities have submitted their budget requests, executives or even a law-making body must set budget priorities. This is a drawback for programs with less political power if they need additional funding to meet program objectives; they will be denied because extra funding are usually given to programs with the most political power.

To summarize, Performance budgeting is a helpful procedure for performance accountability and budget precision. Performance Budgeting cannot be accepted to be a mechanistic, rational system that reinstates the political process of making resource choices in multifaceted environment of competing demands. But, it has the capability of facilitating informed choices. Transparency of the budget and citizens' evaluation of outputs if embodied in performance budgeting can be supportive to enhance budgetary results. Management scholars stated that performance budgeting is an expensive process but it gives positive net benefits if accompanied by performance management culture and results-accountability to residents.