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How to Prepare Flexible Budget?

In those industries where the pattern of demand is stable, a fixed budget may be adequate, especially where the budget period is comparatively short. In such businesses, it is possible to forecast sales with a considerable degree of accuracy.

There are many undertakings where stable conditions are absent. In such concerns, it is usual to adopt the flexible budgetary technique. A flexible budget is a budget which is designed to change in accordance with the level of activity actually attained.

If flexible budgeting is adopted, a series of budgets would be compiled to cover the range of levels of activity possible. In such budgets the division of costs and expenses into fixed and variable categories is very important.

The need for a flexible budget arises from the fact that some expenses are fixed in nature irrespective of the levels of activity, some are variable, which change with the levels of activity, and some expenses are partly variable and partly fixed in nature, which do not vary directly with the levels of activity.

The underlying principle of a flexible budget is that for any given volume of business there should be some norm of expenditure and that norm should be known beforehand to provide a guideline to actual expenditure.

To recognize this principle is to accept the fact that every business is dynamic, and ever changing. It is futile to expect a business to conform to a fixed and preconceived pattern.

Preparation of flexible budget results in the construction of a series of formula, one for each department or cost center. The formula for each account indicates the fixed amount and/or a variable rate.

The fixed amount remains constant regardless of activity and the variable portion is expressed in relation to a base such as direct labour hours, direct labour cost, or machine hours.

Originally, the flexible budget idea was applied principally to the control of departmental factory overheads. In recent years, the idea has, however, been applied to the entire budget so that production budgets as well as selling and administrative budgets are prepared on a flexible basis.

The construction of a flexible budget is identical with that of a fixed budget, except that a budget is prepared for each volume ranging from a possible 60% to 100% of capacity.

When actual figures are available, estimates previously determined for the level attained are compared with the actual results, and the differences are noted. The end-of-period comparison is used to measure the performance of each department head.

It is this readymade method of comparison that makes the flexible budget a valuable instrument for cost control. The flexible budget assists in evaluating the effects of varying volumes of activity on profits and cash position.

Example 1:

The following data are available in a manufacturing company for the half-year period ending 30th June, 1999:

	Rs. (lakhs)	
<i>Fixed expenses:</i>		
Wages and salaries	8.4	
Rent, rates, and taxes	5.6	
Depreciation	7.0	
Sundry administrative expenses	8.9	29.9
<i>Semi-variable expenses: @ 50% of capacity -</i>		
Maintenance and repairs	2.5	
Indirect labour	9.9	
Sales department salaries etc.,	2.9	
Sundry administrative expenses	2.6	17.9
<i>Variable expenses: @ 50% of capacity -</i>		
Material	24.0	
Labour	25.6	
Other expenses	3.8	53.4

It is assumed that fixed expenses remain constant for all levels of production; semi-variable expenses remain constant between 45% and 65% of capacity, increasing by 10% between 65% and 80% of capacity and 20% between 80% and 100% of capacity.

Sales at the various levels are:

60% capacity	Rs. 100.00 lakhs
75% capacity	120.00 lakhs
90% capacity	150.00 lakhs
100% capacity	170.00 lakhs

Prepare a flexible budget for the half-year and forecast the profile at 60%, 75%, 90% of capacity.

Solution:

Flexible Budget for the Half-Year Ending 30th June 1999

(Showing the forecast of profit of different levels)

Elements of cost	Operating capacity				
	50%	60%	75%	90%	100% standard
A. Fixed expenses:					
Wages and salaries	8.4	8.4	8.4	8.4	8.4
Rent, rates and taxes	5.6	5.6	5.6	5.6	5.6
Depreciation	7.0	7.0	7.0	7.0	7.0
Sundry Expenses	8.9	8.9	8.9	8.9	8.9
	29.9	29.9	29.9	29.9	29.9
B. Semi-variable expenses:					
Maintenance and repairs	2.5	2.5	2.75	3.00	3.00
Indirect labour	9.9	9.9	10.89	11.88	11.88
Sales Dept. salaries	2.9	2.9	3.19	3.48	3.48
Sundry adm. expenses	2.6	2.6	2.86	3.12	3.12
	17.9	17.9	19.69	21.48	21.48
C. Variables expenses:					
Material	24.0	28.80	36.00	43.20	48.0
Labour	25.6	30.72	38.47	46.08	51.2
Other expenses	3.8	4.56	5.70	6.84	7.6
	53.4	64.08	80.17	96.12	106.8
Total cost of production (i.e.) Total of A B and C	101.2	111.88	129.76	147.50	158.18
Profit (+) or Loss (-)	—	- 11.88	- 9.76	+ 2.50	+ 11.82
Sales		100.00	120.00	150.00	170.00