

# **A COMPREHENSIVE BUDGETING SYSTEM**

## **A CASE STUDY OF HERBS PRODUCTION AND PROCESING COMPANY LIMITED**

**A THESIS**

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**SUBMITTED TO:  
OFFICE OF THE DEAN  
FACULTY OF MANAGEMENT  
TRIBHUVAN UNIVERSITY**

*In partial fulfillment of the requirements for the Degree of  
Master of Business Studies (MBS)*

**New Baneshwor, Kathmandu  
December, 2012**

# RECOMMENDATION

This is to certify that the Thesis

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*Entitled:*

**“A COMPREHENSIVE BUDGETING SYSTEM”**

*has been prepared as approved by this Department in the prescribed format of  
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# VIVA-VOCE SHEET

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## DECLARATION

I hereby declare that the work reported in the thesis entitled “**A comprehensive Budgeting System.**” A Study submitted to Nepal Commerce Campus, Faculty of Management, Tribhuvan University is my original work done in the form of partial fulfillment of the requirement of the degree of Master of Business Studies (M.B.S.) under the guidance and supervision of Dr.Sushil Bhakta Mathema of Nepal Commerce Campus, Tribhuvan University

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## ACKNOWLEDGEMENTS

This thesis entitle “A **Comprehensive Budgeting System**” has been Prepared in partial fulfillment for the degree of Masters of Business Studies (MBS) under the supervision of **Dr. Sushil Bhakta Mathema** of Nepal Commerce campus. Many have made contributions in different ways to bring out it in this shape. I am thankful to Tribhuvan University, Faculty of Management for providing me such opportunity to experience the practical knowledge of my subject. While preparing this thesis, I was encountered with different realities and facts of the real field. It is my privilege of getting helps and co-operation from different persons. It is not possible to enumerate the names of all of them. However, it will be matter of injustice if I forget the names of those personalities whose valuable suggestions and cooperation escorted to complete this thesis report.

It is the result of cooperation and support of many people. First of all, I would like to extend my sincere gratitude to my thesis supervisor **Dr Sushil Bhakta Mathema** for his effective guidance, valuable suggestions, critical comments & continuous cooperation.

I am also gratefully indebted to all the staffs of Nepal Commerce campus Library, Central Department Library, my family members, friends Sovit karki, Rajish Pokharel Ram kumar Basnet, my wife Shaibya chalise and Everest bank family B/O Maitidevi who helped me in preparation in various aspects of this thesis.

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## ABBREVIATIONS

BEP	: Break Even Point
BSML	: Butwal Spinning Mills Limited
CO.	: Company
CV	: Co-efficient of Variation
CVP	: Cost Volume Profit
e.g.	: Example
FY	: Fiscal Year
GDP	: Gross Domestic Product
HPPCL	: Herbs Production and Processing Company Limited
i.e.	: That Is
MBS	: Masters in Business Studies
Mt.	: Mount
NIDC	: Nepal Industrial Development Corporation
NPC	: National Planning Commission
PE	: Public Enterprise
PPC	: Profit Planning and Control
RDL	: Royal Drug Limited
NAC	: Nepal Airlines Corporation
Rs.	: Rupees
SAARC	: South Asian Association of Regional Co-operation
TU	: Tribhuvan University
UK	: United Kingdoms
USA	: United States of America

# **Chapter –I**

## **Introduction**

### **1.1 General Background**

Profit is a measure of tangible expression of performance towards achievement of entity objectives and goals. A firm's objective is to maximize its profit by providing quality goods and services. Profit in a firm does not just happen; it must be well planned. For this purpose, a comprehensive profit planning and controlling system is applied in the firm.

A comprehensive profit planning and controlling system is a process designed to help management effectively in performing significant phase of planning and control functions. Management process collectively constitutes with the functions of management (i.e. planning, organizing, staffing, leading and controlling). The management process usage sequential linkage from planning to control function and continuous feedback from all other functions to planning functions. Out of the management functions, planning and controlling functions are the key parts of comprehensive profit planning and control system. (Welsch, Hilton and Gordon, 1999:30).

Planning and controlling are closely related, because control is not possible without plans; and planning has no sense without controlling. The essence of planning and control depends on some fundamental or philosophical views of the real role of management in the endeavor. In harmony with these views, profit planning and control depends on the sincere belief of management that it can plan and control long-term destiny of the firm by making a continuing stream of well –conceived decisions. For this reason, there must be a stream of managerial decisions in the firm so that reasonable profit and return on investment can be earned.

“A comparative profit planning and controlling is a systematic and formalized approach for stating and communicating the firm's expectation and accomplishing management in such a way that maximize the use of a profit plan and to achieve the maximum benefit

from the resource available to an organization. It is the only comprehensive approach to managing so far developed that if utilized with sophistication and good judgments, it fully recognizes the dominant role of the manager and provides as framework for implementing such fundamental aspects of scientific management as management by objectives, effective communications, participative management, dynamic control, continuous feedback, reasonability accounting , management by expectation, and managerial flexibility.”(Welsch G, Budgeting, 1976:3)

Because of flexibility in application, profit planning and control model varies according to the nature and size of firm regarding its procedures, formats and rules. Profit planning and control constitutes systematic planning and control system so that it can take the best use of the opportunities and strengths and minimize the threats and weaknesses to meet the target profit. Profit planning and control may be viewed as the most important but sophisticated model that has been developed to facilitate effective performance of the management process. Ultimate objective of profit planning and control model is to attain optimum profit.

Use of the profit planning and control system in a firm, be it a private or a public, helps improve their performance. This study, therefore, attempts to have an insight into the profit planning and control system in public enterprises in Nepal. For this reason, Herbs Production and Processing Company (HPPCL) is taken as a unit of the study.

## **1.2 Industrialization and Public Enterprises in Nepal**

Nepal is one of least developed countries. Over 83% of 26.6 million people of the country live in the rural areas. (Statistical Year Book 2011: IV). They suffer from the lack of minimum facilities that are necessary for living as human being due to underdevelopment and their poverty. Economic growth of the country has not improved markedly over time to overtake population growth. The annual growth of population in Nepal is 1.4 per cent which is a little less than what was found 10 years ago. In 2001, the

population growth was 2.25 per cent. So there is great challenge to the nation to eliminate the massive poverty in the economy and provide basic needs to the people. Keeping in view this challenges, efforts are underway to improve the quality of life of the Nepalese people.

Nepal is an agricultural-based country. Little over half of the population of working age reported economically active and among of them 66% were engaged in agricultural activities. (Dept of Agriculture2011:1). agriculture, which dominates the economy of Nepal, accounts for about 39% of GDP and supplies about 80% of all the nations industrial raw materials. Although agricultural productivity is gradually declining, slowing down overall economic growth. Like most of the developing countries, one of the most important aspirations of Nepal has been to bring about a structural change that transforms its agricultural economy into industrial one.

Industrialization is universally accepted as a strong vehicle of economic development. Industrialization when promoted in efficient lines, it can hold out prospects of abundance of manufacturing goods, increased employment , fuller utilization of natural, capital and human resources of the country; improved balance of payment and above all greater efficiency and modernization through out the economy.

Nepal's entry into industrialization happened during the beginning of the twentieth century. The first industrialization initiative was taken by the private sector spurred by the scarcity of goods created by the World Wars I and II. However, its pace has ever remained very slow. Due to the lack of sufficient capital, technical know-how and the lack of infrastructure, the private sector has been reluctant in investing in the areas of the public utility and innovative industries. For this reason, public enterprises played major role in pursuing the industrial activities of the country. The actual process of industrialization, thus, began since the early 1960's. To accelerate the process of the industrialization and to play a catalytic role in the promotion of economic growth, most of the public enterprises in Nepal were set up in the 1960s and 1970s mainly through foreign assistance. Then, public enterprises were established as a vehicle of socio-

economic development with the initiative and leadership of the government for the economic development of the country.

All the public enterprises in Nepal are incorporated in three forms of organizational patterns. They are as follows:

- a. Departmental Organizations: Such public enterprises run as government departments, however they perform some kind of commercial activities. The most glaring example of this form of public enterprise is the postal department.
- b. Statutory Corporations: These public enterprises are incorporated under special statutes. NAC, NIDC, Electricity Authority are some of the statutory corporations of Nepal. This type of public enterprises is fully owned by government
- c. Government Company: Some public enterprises are incorporated under the Companies Act, 2063. They are mostly manufacturing and trading concerns. The examples of the government companies are Herbs Processing & Production Company Limited, Janakpur cigarette factory Ltd., Hetauda Cement Factory Ltd, Birgunj Sugar Mill Ltd. and so on. These companies are either fully owned or partially owned by the Government of Nepal with majority of equity.

The most of public enterprises are, however, established on an *ad hoc* basis to solve the immediate problems rather than on planned basis. Therefore, most of them have failed to achieve their goals and to contribute to the national development due to their poor performance. As a result, huge sum of public funds have drained out in the form of government grants to these public enterprises. Therefore, the government has recently pursued the policy for their privatization.

### **1.2.1 Performance of Public Enterprises in Nepal**

It is now obvious that Nepal's public enterprises have dismal performance. One of the reasons for such performance is goal ambiguity. The goals of public enterprises in Nepal are not clear, as they have to tend to achieve the conflicting goals of making

profit and meeting social obligation. The Nepalese public enterprises are thus simultaneously oriented towards the social and commercial goals.

Most of the economists agree that public enterprises should run in business line and make profit though they have social motive, and the performance of public enterprises have to be evaluated on the basis of their profitability.

In addition, a number of factors are responsible for dismal economic condition of these public enterprises. The management of the enterprises has tended to be oriented more towards administrative and political matters than towards their business. As the top management of the enterprises is politically appointed, they have more political loyalty and commitment than the interests of the enterprises. Therefore, decision-making process apparently lacks effectiveness and efficiency. Moreover, there had been a marked decline in management accountability. Consequently, the internal operation and control systems have not been in conformity with professional norms, values and principles. Due to the lack of managerial autonomy, the working styles and concerns tend to undermine rather than to promote the interests of the enterprise.

It is obvious that continued inefficiency and ineffectiveness of these enterprises have a profound negative impact on the economy particularly on the issues of sustainability and their overwhelming demand on the government resources. Besides, the lack of clear definition between private and public sector leads both the sectors to unfairly compete against each other in all areas of manufacturing, trading, services, and the like. Under these circumstances, profit planning is necessary for the enterprises of both the sectors complex and uncertain context of economic liberalization, privatization and globalization of the world economies.

### **1.3 Unit of the Study**

The study is basically concerned with the study of the application of profit planning and control system in the public enterprise especially in manufacturing enterprise and as a

unit of the study, Herb Production and Processing Company Limited (HPPCL) is taken as the manufacturing public enterprise. The company is established in the course of industrialization and development of herbs in Nepal.

### **1.3.1 Introduction of HPPCL**

A new chapter in the history of the herbal extracts and essential oils commenced with the establishment of Herbs Production & Processing Company Limited in 1981 as a government undertaking. The company was incorporated under the Companies Act 2021 as Government Company. After through research and dedication of the core of national scientists under the Department of Medicinal Plants, this company was founded.

The HPPCL has an authorized capital of Rs 50 million, of which Rs 38.6 million has been issued and Rs 2, 75, 17,000 has been already paid up. Shareholders of HPPCL and the percentage of their ownership are as follows:

<b><u>Shareholders</u></b>	<b>Percent of ownership</b>
a) Government of Nepal	80.73%
b) Forest resource Development Committee	3.37%
c) Royal Drugs Limited	3.37%
d) Agriculture development Bank	2.89%
e) Public	9.64%
	<hr/>
	Total 100.00

The HPPCL branches are located at different parts of the country.

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## **General Program:**

The company produces essential oils and medicinal extracts using indigenous Himalayan herbs and exotic conventional vegetation as raw materials. The sources of materials are cultivated in its own and private farmland and collection from wild sources. The major activities of the company are:

1. Cultivation and processing of medicinal and aromatic plants: The Company owns areas of 359 hectares in Tamagadi farm and 70 hectares in Belbari branch office for cultivation of medicinal and aromatic plants.
2. Production and processing of essential oils and medicinal extracts: The Company has a central factory at Koteshor, Kathmandu for processing of raw herbs and producing herbal products and essential oils and medicinal extracts. It has processing and production units in every farm and in the private farmers' vicinity.

### **1.4 Statement of the Problem**

HPPCL is the largest government industry in the herbs sector and is the exporter of herbal oils and products. However, the financial statements of HPPCL show that it is suffering from continuous operating losses for some years in the recent past. One of the reasons for such a consequence may be due to the lack of its effective and efficient management. Since profit planning and controlling systems are one of the approaches of effective and efficient management. This study is directed towards examining the effective and efficient application of profit planning and control system in HPPCL.

The study has attempted to answer the following research questions:

1. Does HPPCL apply any form of comprehensive PPC system?
2. Does HPPCL prepare any kind of profit plans? If yes, are they effective?

3. How does the company prepare sales budget, production budget and material purchase budget? Does HPPCL have any systematic way of preparing these budgets?
4. Does HPPCL maintain stock level materials and outputs? What kind of inventory policy is it following?
5. How is HPPCL planning cash? Is there continuous monitoring of cash position?
6. What are the major problems faced by HPPCL in developing profit plans?
7. What is the trend of overall profit plan in HPPCL?
8. How positive is the relationship between budgeted and actual performance?
10. Is there any need for improvement in its PPC system?

### **1.5 Objective of the Study**

The basic objectives of the study have to have an insight into the PPC system and appraise its effectiveness in Herbs Production & Processing Company Limited. The study also seeks to achieve the following specific objectives:

- 1.To examine the profit plan of HPPCL
- 2.To analyze the various functional budgets adopted by HPPCL
- 3.To examine the relationship between budgeted and actual trends of HPPCL over the study period, (2063/64-2067/68).

### **1.6 Need of the Study**

Nepal is bestowed with a range of geo-climatic conditions, which favor the growth of much kind of medicinal and aromatic plants, indigenous herbs, which serve as a valuable natural wealth of country. HPPCL is the pioneer company in the sector of collecting, producing, processing and marketing of medicinal and aromatic herbs in the country in an

organized way. Therefore, HPPCL can considerably contribute the pace of industrialization and development of the country in this regard. To attain the objective of HPPCL, profit planning and control system seems to be essential. The present study is, therefore, undertaken to analyze and examine the application of profit planning and control system in HPPCL.

### **1.7 Scope and limitations of the study**

The study is concerned with one of the approaches of management, viz. profit planning and control in HPPCL. It is however by no means concerned with the study of its management and does not cover any other areas of the Company than its budgeting system.

Besides, the study is suffers from some limitations, which include:

1. The study has used the data of 5 years only, i.e. fiscal year 2063/64 to 2067/68.
2. The accuracy of the analysis of data will depend upon the accuracy of the data gathered from HPPCL.
3. The comprehensibility of the study will also be dependent upon how far the enterprise has adopted profit planning and control system.

### **1.8 Organization of the study**

The study is organized into the following five chapters:

1. **Introduction:** This chapter deals with the general background of the study, industrialization and public enterprises in Nepal. Moreover, it includes a brief profile of the unit of study, i.e. HPPCL, statement of the problem, objective and

need of the study. The scope and limitations of the study are mentioned and organization of the study has been presented in the chapter.

2. **Review of Literature:** This chapter presents the review of the concepts of profit planning and control in manufacturing enterprises. This chapter mainly focuses on fundamental, components and process of profit plan and on performance evaluation and underlying concepts. Thus, this chapter is concerned with formulation and implementation of profit planning and control. It also include a brief review of previous research studies pertaining to profit planning and control in public enterprises, specially in manufacturing public enterprises in Nepal.

3. **Research Methodology:** This chapter represents the research methodology that consists of the research design, data collection and processing procedure and tools and techniques of analysis procedure.

4. **Data Presentation and Analysis:** This chapter provides the current practice and application of profit planning and control in Nepalese manufacturing public enterprise specifically in HPPCL. It focuses on data presentation and analysis and interpretation with the help of selected tools and techniques within the “frame of reference”. Furthermore, it includes the findings of the research study.

5. **Summary, Conclusions and Recommendations:** This chapter is the final part of the study. This part consists of conclusion of this research study and offers the recommendations to improve the present situation in HPPCL.

A bibliography and Appendixes have been included at the end of the study.

## **Chapter II**

### **Review of Literature**

#### **2.1 Introduction**

This chapter presents the review of the concepts of profit and profit planning and control, origin, importance and components of profit planning and control, profit planning and control process, budgeting and profit planning, master budget, capital expenditure budget, and review of earlier studies.

#### **2.2 Profit**

Profit is the primary motive of a firm. The reliable measure of the effectiveness of performance of a business is profit. Profit is thus the primary measure of success of the business performance. Simply stating, profit is the excess of income over cost of production. “Profit” is very controversial and there are several different interpretations about this. An economist will say that profit is the reward of entrepreneurship for risk taking. A labor leader might say that it is a measure of how efficiently labor has performed and that it provides a base for negotiating a wage increase. An investor will view it as a gauge of the return on his or her money. An internal revenue agent might regard it as a base for determining income taxes. The accountant will define it simply as the excess of firm’s revenue over expenditure of producing revenue in given fiscal period. (Lynch and Williamson, 1992:99)

Using the accountant measuring stick, management thinks of profit as:

- A tangible expression of the goals it has got for the firm.
- A measure of performance towards the achievement of its goals
- A means of maintaining the health, growth and continuity of the company.

A view of profit states that the entrepreneur is special type of labor and profit is special form of wages. The entrepreneur earns profit for gathering and organizing the other

factors of production land, labor, and capital for producing goods or services and thereby earning profits.

Several economists have their different views in respect of the term profit. According to F.B.Hawley, profit is the reward for risk taking in business. Schumpeter expressed that entrepreneur earns profit as reward for his introducing innovation. J. M. Keynes held the view that profit resulted from favorable movement of general price levels. Robinson and Chamberlain opined that the greater the degree of monopoly power the greater the profits made by the entrepreneurs. (Joshi, 2057:170)

At last, it should be noted that profits are residual income left after the payment of the contractual to other factors of production.

Economic theory of profit may be put into three broad groups:

- Profit is the reward for bearing risk and uncertainties
- Profit as the consequence of frictions and imperfection in the competitive adjustment of the economy to dynamic change.
- Profit as the reward for successful innovation.

It clearly shows the differences among economists in regard to the meaning of profit. In general, there are four types of production factors i.e. land, labor, capital and organization. The factors of production help to produce goods and services. However, in the course of their assistance in production process they need incentives. Then, the excess of revenue over such incentives is known as profit and profit always belongs to owners. Profits are the excess of the income over cost of production. The expenses made on raw materials, labour, interest on borrowed money, fuel , power are included in cost, the non-cost items such as salary that entrepreneurs would earn, if given to others are excluded from conventional accounting profits because these opportunity cost does not appear to books of account. However, the economists hold the view that the factors should also be subtracted to arrive at net profit. The word “profit” implies a comparison of the operation

the business between the specific dates, which are usually separated by an interval of one year. (Joshi: 2057:170).

The difference between the outflows and inflows is profit. The inflows mean the sales price and the outflows mean the cost of production and sales of the output.

### **2.3 Planning**

Planning is the first and foremost function of management, as all other functions of management are performed within the framework of planning. Planning means deciding in advance what is to be done in the future. Planning starts from forecasting and predetermination of future events. Planning is the whole concept of any business organization. No firm can achieve its predetermined goals and objectives in the absence of proper plan. Hence, it is lifeblood of any organization, which makes it efficiently run towards the competitive environment. The planning process involves both short- and long-term and is the most crucial component of the whole system. It operates as the brain center of an organization. (Munankarmi, 2002:215)

The fundamental purpose of management planning is to provide a feed-forward process for operations and for control. Planning is generally recognized as the most difficult task facing the manager and it is one of the very easy to procrastinate. Feedback is also an important ingredient of both re-planning and control. Planning rests up on the view that the future success of an entity can be enhanced by continuous management actions. Planning must encompass an evaluation because they will have significant impacts on the planning of realistic objectives and goals. The development of enterprise objective is the most fundamental level of decision making in the planning process. The planning level is known as goal, which represents broad objective brought into sharper focus by explicitly specifying,

) Time dimension for attainment

- ) Quantitative measurement
- ) Subdivision of responsibility

The most detailed level of planning occurs when management operation lays the objectives/goals and strategies already established by organization into the profit plan. Planning begins with setting on general goal proceeds to cost –volume-profit analysis of various alternatives and ends with the proportion of the detailed quantitative plan of action budget

## **2.4 Control**

Control can be defined as the process of measuring and evaluating performance of each organizational component of an enterprise and initiating corrective action when necessary to ensure efficient accomplishment of enterprise objectives, goals, policies, standards. Planning establishes the goal, objectives, policies and standards of the firm.

## **2.5 Meaning and Definition of Profit Planning and Control**

Profit planning and control is planning for future operations in such a way to maximize or to maintain a specified level of profit. It is a process that helps management to perform planning functions effectively. A comprehensive profit plan is also known as broad budgeting schedule developed in financial statements. Profit planning and controls deals with the development of objectives, specifications of short-term goals, and development of strategies and tactical profit plan. A profit plan is the detailed expression of expected result from the planning decision.

The descriptive term *comprehensive profit planning and control* can be used in same context as *managerial budgeting*, *business budgeting*. The term comprehensive profit planning and control is defined as systematic and formalized approach of performing significant phase as management planning and control functions. Specially, it involves –  
a. the development and application of the broad and long range objectives, b. the

specifications of enterprises goals, c. a long range profit plan develops in broad term, d. a short range profit plan detailed by assigned responsibilities by divisions, products and projects, e. a system of periodic performance report detailed by assigned responsibilities, and f. follow-up procedures (Welsch, Hilton and Gordon 1999:1). Profit planning is a comprehensive plan expressed in financial terms by which an operation program is effective for given period.

A budget is numerical plan of action that generally covers the areas of revenues and expenditures. The main aims of budgeting are to present the future forecasting. As the size of organization grows the vital of profit planning becomes inevitable. Profit planning is primarily a management tool, a means to get something done over a period of time. A profit planning must be prepared in advance of comprising operations. The profit planning covers a definite period of time usually one year stating what and how things are to be done. It is a tool of directing, coordination and control and as such it is the most important device. (Munakarmi, 2002:215)

## **2.6 Origin of Profit Planning and Control**

Towards the end of 1921, National Budget for the fiscal year 1922/23 was prepared in the USA. With the introduction of national budget in USA, businesspersons started realizing the importance of budgeting. National budget covers or implies on the following:

1. Forecast the probable future expenditure.
2. Analysis of the sources from which income is to be realized to meet the expenses,  
and
3. Maintaining coordination between expenses and source of income.

During that time, USA businessmen were also suffering from the problem of coordination between expenses for material, rent and labor etc and receipt from sales, so they started thinking about adaptation of budget. Gradually they started adopting the budget. This can be considered as the origin of PPC.

The first ever written in business budget was published in UK in 1932. The title of the book was, “*business budget and budgetary control*” and was written by A.W.Willsome. The book is a collection of six articles written by him, which were published in “The Times” engineering supplement published between 5-12-1931 to 6-12-1932, but this philosophy could not get popularity in UK before 1936.

Mr. R Dankerly motivated British business by presenting interesting reviews on several industries of USA at sixth International Engineering for Scientific Management held in London in 1935. But actual popularities of profit planning and control were gained after the introduction of Marshall Plan.

## **2.7 Components of Profit Planning and Control**

A Profit Planning and Control program should have all its components that are required to fulfill the objectives which are supposed to be fulfilled by PPC program. Welsh, Hilton and Gordon have presented the following components of PPC program: (Welsh, Hilton and Gordon: 1999, 61)

- A. The substantive plan
  - i. Broad objectives of the enterprise.
  - ii. Specific enterprise goal
  - iii. Enterprise strategies
  
- B. The financial plan
  - 1. Strategic long –range profit plan
    - i. Sales, cost and profit projection
    - ii. Major project and capital additions
    - iii. Cash flow and financing
    - iv. Distribution expenses budget

2. Tactical and short –range profit plan
  - a. Operating plan (planned income statement)
    - i. Sales plan
    - ii. Production plan
    - iii. Administrative expenses budget
    - iv. Distribution expenses budget
    - v. Appropriation type budget (e.g. R&D, promotion, advertising)
  - b. Financial position plan (Planned balance Sheet)
    - i. Assets
    - ii. Liabilities
    - iii. Owners equity
  - c. cash flow plan
  - d. variable expenses budget
    - i. output expenses formulas
  - e. supplementary data
  - f. follow up, corrective action and re-planning report

## **2.8 Profit Planning and Control Process**

Comprehensive profit planning and control entails a systematic approach to management focusing on a quantitative evaluation of the result of managerial objective and dynamic control through application of the management exception principal (Welsch, Hilton and Gordon, 1999:60). A profit planning and control program includes more than the traditional idea of a periodic or master budget. Rather, it encompasses the application of a related management concept through a variety of approaches, techniques and sequential steps. The term comprehensive means:

- The applications of the broad concepts of profit planning and control to all phases of operations in every enterprise

- The application of total system approach. (Welsch, Hilton Gordon, 1999:61)

Consistent with the PPC process the major components of it are as follows:

- a. The substantive plan
- b. The financial budget
- c. Variable expenses budget
- d. Supplementary data, and
- e. Performance report

The *substantive plan* is represented by the broad objectives, strategies, special plans and program of the organizations by the commitment management long range accomplished of the objectives and plan. It gives the foundation for the financial plan.

The financial plan quantifies the planned financial results of implementing managerial objectives, planned strategies, plans and policies. The financial plan then represents a translation into financial terms of objectives goals and strategies of management for specific period of time.

The planning process should involve periodic consistent and in-depth preplanning so that all aspects of operations are carefully examined and reevaluated. This prevents a budget planning approach that involves only justification of increase over the period. The concept of revaluation is necessary to justify all aspects of the plans “periodically finds the strongest support in what has been called zero base budgeting. (Peter, 1973: 93).

## **2.9 Importance of Profit Planning and Control**

A comprehensive profit planning and control is a systematic and formalized approach for stating and communicating the firm’s expectation and accomplishing management in such a way to maximize the use of a profit plan and to achieve the maximum benefit from the resources available to an organization over a particular span of time. A profit

planning and control is of immense value to management. It helps planning, coordinating and controlling if used appropriately. PPC involves development and accomplishing of broad objectives and goals to move and organization effectively.

In the view of many businesses, the main objective of the business is to earn reasonable profit. In the last few years, however, most of them have tended more frequently to soft-pedal profit maximization and to emphasize the modern cooperation going test of social obligation, i.e., “Social responsibilities”. Profit is indispensable element. A firm making inadequate profit will not only struggle to survive but will perhaps become a social or economic disaster to the concept to support. Social responsibility is fair weather concept. Management cannot begin to think in terms of philanthropy unless profit is adequate. (Welsch, Hilton and Gordon, 1999:254)

Management must execute a series of thinking processes and action that guide it to produce or render service in a definite manner of method in a volume at a time, at a cost and at a price that will in a long run assure a profit and also with the cooperation of employees gain the goodwill of customers and meet social responsibilities.

Business logic and changing public expectations suggest that the plan should be formulated within four major parameters: economic, social, technological and political. Business enterprise must always think about sound profit planning. Profit planning has following importance and advantages in an enterprise:

1. It focuses on basic policies.
2. It requires adequate and sound organizational structure.
3. It combines all members of management from top to down to participate in the establishment of goals and plan.
4. It helps departmental manager to make plan in harmony with the plans of other department and of entire firm.
5. It finds the deviations and guides management to take corrective actions for satisfactory performance.

6. It uses adequate and appropriate historical accounting data.
7. It helps management to plan the most economical use of labor, material, facilities and capital.
8. It installs at all level of management that habit timely, careful and adequate consideration of all the relevant factors before reaching important decision.
9. It reduces cost by increasing the span of control since less supervision is needed.
10. It freshen executives from day-to-day internal problem through the predetermined policies and clear-cut authority relationship and provides more executive time for planning and creative thinking.
11. It pin points efficiency and inefficiency.
12. It tends to remove the cloud of uncertainty.
13. It promotes understanding among member of management about their worker problem.
14. It forces a periodic self-analysis of the company.
15. It aids in obtaining save credit.
16. It forces the management to give the time and adequate attention to the effort of the expected trains of general business condition.
17. It checks progress or lack of progress towards the objective of enterprise.

Though profit planning and control has real influence and versatile importance in this new competitive business environment. (Welsh, Hilton and Gordon: 255)

## **2.10 Budgeting and Profit Planning**

Planning begins from the establishing objectives and end with the preparation of budget. A budget is a comprehensive plan of action prepared and approved to defined period of time usually showing planned income to be generated and/or expenditure to be incurred during that period of the capital to be employed to attain a given

objective. It expresses an organization's commitment to planned activities and resource acquisition and use. It is a vital part of good planning. It is formal statement of plans usually expressed in monetary terms. Therefore budget is;

- ) Essentially a plan (quantifies in monetary terms) to attain a given objectives.
- ) Prepared and approved
- ) Prior to define period of time (known as budget period).
- ) Usually showing planned income to be generated.
- ) Expenditure to be incurred, and
- ) Capital to be employed during that period

The process of preparing budget is known as budgeting. This is the process of planning future business actions and expressing those plans in a formal manner is called budgeting. It serves to coordinate the organizations many activities. (Munakarmi, 2002: 215) Budget occupies a leading place among the special tools of management employed to direct and control the organization. It has become one of the recognized aids to management both for formulating policy and for keeping check on its execution. Budgeting is necessary and most important tool for efficient administration in any organization.

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A budget imposes operational standards with accountability for performance and it must be set with these objectives in view. Therefore, the aim of every company should prepare its budgets meticulously, systematically and factually and as an instrument of management control.

“Budgetary control system which uses budgets as a means of planning and controlling all aspects of producing or selling commodities or services .ICMA defines budgetary control as it is the establishment of budget relating the responsibilities of actual with budgeted results, either to secure by individuals action of the objective of that policy to provide a basis for its revision.”(Ratnam, 1994:2)

Budgets do not only compare the actual results with budgeted standard but also provide a standard of performance of the business enterprise. Company controls operation through its budgeting and responsibility reporting system. Top executives are able to control every area of the organization through a system of budgetary planning and control reporting by responsibility areas. Yardstick of performance are provided for all productive and service areas and results of operation are accumulated and reported in terms of these yardstick at all supervisory levels.

### **2.10.1 Features of Budget**

The following are the key features of a budget:

- ) To determine the objective to be achieved
- ) To identify the policies to be adopted for achieving budget objectives
- ) To determine the activities to achieve the budget objectives
- ) To prepare physical and monetary plan for each activity for budget period
- ) To have a practice of comparison of actual performance with budget for each and every department and find the cause of variation
- ) To have a policy of necessary actions if actual work is not within plan and if require revise the plan
- ) To have a policy of necessary actions if actions if actual work is not within plan and if required revise the plan.(Munankarmi, 2002: 216)

### **2.10.2 Importance and Advantage of Budget**

The following are the important advantages of a budget:

1. Helps to earn more profit
2. Motivates the manager to prepare plan for budgeted program
3. Basic policies will be determined
4. Top management will involve in budget committee, which will provide experienced and efficient planners
5. Every department will have to plan which will coordinate the plan of other department
6. Inefficiencies will be point out in time
7. Maximum utilization of resources will be possible
8. Help to cultivate the habit of gathering information require for decision making
9. Helps to the revision of policies for smooth operation of activities
10. It helps to cultivate the habit of diagnosing the problems among the staff
11. Help to necessary co-ordination among staff, departments planned, activities etc.
12. Compel to have attention towards changing business environment

(Munankarmi, 2002: 216)

### **2.10.3 Objectives/Purposes of Budget**

The main and most important objective of the budget is to achieve the planned profit of the business enterprise. Thus, it is considered as a main tool for planning and controlling the profit. One of the primary objectives of an annual budget is to measure the profit expectation for the next financial year with due regards to all the circumstances favorable that can influence the trading prospects.

Many renowned authors hold different view about the purpose of the budget but they are in a similar way. According to Ratnam, the following are the objectives of setting budgets.

- It is a plan of action and serves as a declaration of policies.
- It defines the objectives for all the executives.
- It provides a means for coordination and communication.
- Budgets facilitate centralization control with delegated authority and responsibility. It provides comparison of actual performance with budgets.
- Only the expectations are reported to the management so that corrective action can be taken in order to achieve the objective laid down by the management.(Ratnam, 1994: 4)

Halshall gave his view regarding operating budgets as a following:

- It is a plan which reflects the policy of a business in financial terms.
- It is control document by which management can monitor actual performance.
- It acts as motivator for employees.
- It is a means which evaluates the quality of management.
- It is a means of forecasting future financial position.
- It is a means of giving information on an organization, future attention.

The purpose of budgeting in the context of an annual budget is to project accurately the sales income, expenditure and profit for the ensuing year. This is the principle objective and all other requirements of budgeting.

Similarly, Edwards and Hines has mentioned the following purpose of budgets: “There are four main purpose of budget and any or all may reflect in any one budget. First, a plan sets out the proposals and decisions of those running the organization. Second, a forecast of the result is expected. Third, an authorization, the instrument whereby supreme governing body sanction raising the revenues or incurring the expenditure ought to be if the organization is working efficiently.(Edwards and Hines, 1959:19)

#### **2.10.4 Types of Budget**

Budget can be classified into various functional budgets with reference to planning and control. However, in an operational term a comprehensive budget has several components. Normally it consists of three types of budgets.

- a. operational budgets
- b. financial budgets
- c. Special decision budgets

Another classification of budget is:

- a. Fixed/static budget
- b. Flexible /variable/sliding budget

Operational budget: operational budgets are related to physical activities/operation of a firm such as sales, production, purchasing, debtor's collection and creditor's payment schedules. In specific terms, an operation budget has the following components.

##### **1. Sales plan**

- a. Sales plan
- b. Selling and distribution cost plan

##### **2. Production plan**

- a. Raw material plan
- b. Purchase plan
- c. Labor hour and cost plan
- d. Inventory plan
- e. Manufacturing overhead plan

### **3. Administrative overhead plan**

Financial Budgets: Financial budgets are concerned with expressed cash receipt/distribution, financial position and result of operations. a financial budget has the following components

1. Cash plan
2. Budgeting income statement
3. Budgeted statement of retained earning
4. Budgeted balance sheet etc.

Special decision budgets: Special decision budgets are related with the special and long term decision, which may be controllable and uncontrollable of the firm . a special budget has the following components.

1. capital expenditure plan
2. research and development cost plan
3. Plant utilization plan etc.

### **2.11 Master Budget**

While preparing the budget planning of the company, there will be different process of preparing the functional budgets. Those functional budgets are mainly sales budget, production budget , material purchase and usage budget, labor budget , expenses budget , overhead budget , cash budget.,, departmental budget etc. to calculate the overall income and expenditure of the company the summarization of all those functional budget into a clear statement is necessary other wise we cannot get the overall picture of the business enterprise.

The overall budget for a firm is called the master budget. The master budget includes many functional budgets. Master budget is consolidating of the entire different departmental and sectional budget. By this, the organization forecasts the total income and total cost and expenses for the budget period.

The master budget is the organizations short-term budgetary device. The preparation of a master budget is a complex process and it involves the efforts of many people from all level of management. There are twelve basic steps in preparing a master budget for a business firm. (Welsch, Hilton and Gordon, 1999:272)

These steps are as follows:

- Step 1 Forecast demand for products and services.
- Step 2 Identify cost patterns for responsibility centers.
- Step 3 Estimate production cost
- Step 4 Specify operating expenses.
- Step 5 Develop a production budget.
- Step 6 Develop a purchasing budget.
- Step 7 Develop budgets for responsibility centers.
- Step 8 Formulate a profit plan.
- Step 9 Compare profit plan with operating objectives.
- Step 10 Formulate Projected statements of financial position.
- Step 11 Prepare a projected statements of financial position.

The complete budget for a firm is often called the master budget. The master budget consists of many functional budgets. These budgets include a sales budget, a production budget, a purchase budget and a cash budget. Once all of these budgets are completed the master budget for the entire firm is prepared. A master budget is a summary of functional budgets and thus it shows the overall budget plan and profit or loss during the budget period.

## **2.12 Sales Budget**

Sales plan is the starting point in the preparation of the comprehensive profit planning and control. All the other plans and budget are dependent upon the sales budget. The

budget is usually presented both in units and amounts i.e. sales revenue and sales volume. The preparation of sales plan is based upon the sales forecast. A variety of methods are used to forecast the sales for the planning period.

The sales planning process is a necessary part of PPC because:

- a. It provides for the basic management decision about marketing and based on that decision.
- b. “It is an organized approach for developing a comprehensive sales plan. If the sales plan is not realistic, most of the other path of the overall profit plan is also not realistic.” (Gupta, 1995: 521)

The primary purpose of sales plan is

- ) To reduce uncertainty about future revenues.
- ) To incorporate management judgments and decisions into the planning process.
- ) To provide necessary information for developing other elements of a comprehensive profit plan
- ) To facilitate management control of sales activities.(Welsch, Hilton and Gordon, 1999:172)

Unless there is a realistic sales plan, practically all other elements of a profit plan will be out of kilter and reality. The sales plan is the foundation for periodic planning in the firm because particularly all other enterprise is built on it. The primary source of cash is sales. The capital needed the amount of expenses to be planned, the manpower requirements and the production level and other important operational aspects depend on the volume of sales. In harmony with the comprehensive profit plan both strategic and long term, short term sales plan must be developed. Thus, one commonly observes a five-year strategic sales plan. Many management divisions commit a large amount of resources involving a life span of many years. Basic strategies and major moves often involve irreversible commitments of resources and long time span.

### **2.12.1 Sales Planning vs. Sales Forecasting**

Generally, people think that sales planning and forecasting are same: in fact it is not same. A forecast is just a statement of future conditions. The sales budget is not mere forecasting of the future. It is a plan of campaign and it is very necessary that all parties concerned should be aware of any alteration that has been made to their original estimates together with the reasons for and objectives of the alterations.

A sales forecast has to be translated into sales budget and here a number of factors have to be taken into consideration. A sales forecast is converted to sales plan when management has brought to bear management judgment, planning strategies, communities of resources and the management commitment to aggressive actions to attain the sales goal. In contrast, sales forecasting is a technical staff function.

### **2.12.2 Strategic and Tactical Sales Plan**

The strategic sales plan is a long term plan and it usually covers a five or ten years of time horizon and usually it covers one year period. A short –range plan should include considerable details, where as a long –range plan should be in terms.

Long-term sales plans are usually developed as annual amounts and use broad grouping of products. Long-term sales plan usually involve in depth analysis of future market potentials. This may be built up from a foundation such as population changes, state of economy, industry and industry projections and major consideration is to provide details by responsibility for planning and control purpose. The short –range sales plan must provide details needed for completing the profit plan component by others functional managers.

### 2.12.3 Components of Comprehensive Sales Planning

A comprehensive sales plan should satisfy the requirements of and be consistent with the overall comprehensive PPC program. The components of comprehensive sales plan are as follows:

S.No	Component	Strategic Plan	Tactical Plan
1	Management policies and assumption	Broad general	Detailed and specific for the year
2	Marketing plan(sales and service revenue)	Annual amounts, major groups	Detailed by product and responsibility
3	Advertising and Promotion Plan	General by year	Detailed and specified for the year
4	Distribution (Selling expense plan)	Total fixed and total variable expenses by year	Fixed and variable expenses by month and responsibility

### 2.12.4 Developing a Comprehensive Sales Plan

A comprehensive sale of an enterprise can be developed as following steps:

1. Develop management guidelines specific to sales planning including the sale planning process.
2. Prepare one (or more) sales (market) for casts consistent with specified for casting guidelines including assumptions.

3. Assemble all the other data that will be relevant in developing a comprehensive sales plan.
4. Based on 1,2and 3 above apply management evaluation and judgment to develop a comprehensive sales plan.

### **2.12.5 Consideration of Alternatives**

Developing realistic sales plan involves consideration of numerous policies and related alternatives and final choice by executive management. There are mainly two types of problems to which important consideration should be given while preparing the sales plan.

- ) Price cost volume consideration
- ) Product line consideration (Welsch, Hilton and Gordon, 1997:310)

### **2.13 Production Planning**

In a comprehensive profit plan, the requirement of the sales plan must be translated into the supporting activities of the other major functions. In the service company, the sales plan must be converted into service capability requirement: for a retail and whole sale enterprise, the sales plan must be converted into merchandise purchase requirements and for manufacturing enterprise the sales plan must be converted into production requirements. The sales plan specifies the planned volume of each product for each time period through out the planning period. The next step in manufacturing enterprise is to develop efficient production level, use of production facilities and inventory levels. The quantities specified in marketing plan, adjusted to confirm to confirm to production and inventory policies give the volume of good that must be manufactured by product and by interim time period. Thus, production budget can be represented as:

Required production = planned sales + desired ending inventory - Beginning  
inventory of finished goods.

Production manager is responsible person for the production planning. The planning and controlling of production is the main function of production manager planning, scheduling and dispatching of the actual production through out the year are function of the production department and production manager is the head of this department. Therefore, he is responsible for that.

The production managers have first hand knowledge of plant and personal capacities, availability of materials and production process.

While preparing the production planning by top management, policies for inventories level established of production and capital addition for plant capacity must be considered. With respect to production planning the manger must plan and optimum co-ordinate between sales, inventory and production level. The main function of production planning is to maintain production and from suitable production level.

There may be pressure of high level of inventory from both side of sales and manufacturing. So there must be co-ordination between sales plan, production plan and inventory policies. In production budget, an inventory policy provides the basis for obtaining the coordination.

### **2.13.1 General Consideration in Production Planning**

There must be needed coordination between sales, production plans and inventory policies and the production budgets give guidelines to obtain the coordination between them.

The production plan represents the implication of planned sales volume for planned production volume as a basis for planning various aspects of the manufacturing function- plant capacity requirement, direct material and component requirements timing of purchase, direct labor requirement and costs and factory overhead. Other decision should

be in the basis of production plan therefore there should be serious consideration of production plan. Welsch, Hilton and Gordon have mentioned the following eight points to be considered in planning production and inventory levels.

1. Total production requirements (by products) for the budgeted period.
2. Inventory policies about the level of finished goods, work in progress and the cost of carrying inventory
3. Plant capacity policies, such as the limits of permissible departures from a stable production level through out the year.
4. Adequacy of manufacturing facilities (expansion and contraction of plant capacity).
5. Availability of direct materials, purchase components and labor.
6. Length of processing time.
7. Economic lots or runs.
8. Timing of production throughout the budget period by product and by responsibility.

### **2.13.2 Long-range vs. Short-range Production Plan**

To develop a long-range plan board estimate of production levels are necessary to plan plant capacity requirements (involving capital additions), factory cost, structure personnel requirements and cash flows. For long-range planning purpose, only major increases or decreases in inventories need have to be taken into account. But the short-range production plan should incorporate months or quarter's details by products and an annual production plan. In addition, the production activities should be planed by responsibility centers within the manufacturing division.

### **2.13.3 Consideration in Setting Production Policies**

Seasonal sales are typical in most companies. Yet relatively stable production levels usually enhance production efficiency. In many companies where sales of the primary

products are seasonal, developing new product that can store or that have opposite seasonal patterns has stabilized production levels. Inventory fluctuation provides a tempting method leveling production; there are certain pitfalls to be considered. Stabilization of production is desirable for a number of compelling reasons and generally results in significant reductions of cost and improvements in operations. The advantage of relatively stable production levels may be outlined as follows:

1. Stability of employment resulting in:

- a. Improved morale and hence greater worker efficiency
- b. Less labor turnover.
- c. Attraction of better employees.
- d. Reduction of expense for training new employees.

2. Economics in purchasing raw materials as a result of:

- a. Availability
- b. Volume discounts.
- c. Simplified storage problems
- d. Smaller capital requirement
- e. Reduce inventory risk

3. Better utilization of plant facilities which tends to:

- a. Reduce the capacity required to meet peak seasons.
- b. Avoid the capacity

#### **2.13.4 Consideration in Developing Inventory Policies**

In most of the business enterprises, inventory represents a relatively high investment. It has the significant impact in the major functions of the enterprise and its profit; therefore, it should be controlled and monitored by appropriate inventory policies. Welch, Hilton

and Gordon have described the following points to be considered while developing inventory policies.

1. Quantities in units needed to meet sales requirements
2. Perishability of items Length of the production period
3. Storage facilities
4. Adequacy of capital to finance inventory production in advance of sales
5. Distribution time requirements
6. Cost of holding inventory
7. Protection against direct material and component shortages
8. Protection against labor shortage
9. Protection against material and parts prices increases
10. Risk involved in inventory:
  - a. Price declines
  - b. Obsolescence of stock
  - c. Casual loss and theft
  - d. lack of demand
  - e. Customer returns policies.

#### Just in Time (JIT) Production

The just in time approach to production planning is a recent trend in manufacturing. The main characteristics of modern production environments, which JIT is based on, are as follows:

1. It is in efficient and costly to hold large inventories of safety stock for raw materials, sub assemblies of finished products. Therefore, safety stocks should be minimized
2. Setup times for production can be minimized through the use of robotics and process studies. Therefore, frequent production setups may not be inefficient.

3. Very high qualities of subassemblies and final products must be achieved in order to reduce the need for safety stocks.

JIT is a production concept in which virtually nothing is purchased or manufactured until just before it is needed. (Welsch, Hilton and Gordon, 1997:313)

### **2.14 Material Purchase Budget**

After the sales and production budget/plan has been prepared, the next step is to prepare the material purchase budget, when the production budget completes then the requirements of raw material and components to be used in the process of manufacturing the final products could be budgeted or planned. Taking base from the production budget, the quantities of each material to be used will determine and this determination on material usage leads to the solution of the problem of when and how to purchase of each raw material.

The material and purchase budget and its sub budgets should be prepared in such a way that the related activities and cost will be estimate in the terms of responsibility center, interim time periods, types of raw materials and part and type of final product. A purchase budget gives the details of material purchase to be made in the budget period. (Welsch, Hilton and Gordon, 1999: 330)

### **2.15 Selling / Distribution Expenses Budget**

Distribution expenses are related to selling, distribution and delivery of products to customers. Fundamentally, the marketing executive has the direct responsibility for planning the optimum economic balance (for profit potential) between (a) the sales budget (b) the advertising budget (c) the distribution budget. Because of interrelationship between them: sales advertising and distribution expenses should be viewed as one basic problem. Mainly there are two types of selling expenses:

1. Sales offices expenses, which cover the cost of sales man and their administrative support
2. Sales direction and promotion expenses which cover the cost of direction of the sales effort and promotional charges such as advertising. The distribution/selling expenses budget should be planned by interim time periods and by responsibility center, in rear cases this might be by sales region/district and in other cases by products. (Welsch, Hilton and Gordon, 1999:345)

### **2.16 Administrative Expenses Budget**

Administrative expenses include those expenses other than manufacturing and distribution. They are incurred in the responsibility centers to provide supervision of and service to all functions of the enterprise rather than performance of any one function. Generally, administrative expenses are closed to top managements and therefore there is strong tendency to overlook their magnitude and effects of profits. Each administrative expense should be directly identified with responsibility center and the center manager should be responsible for planning and controlling the expenses. Budgeted administrative expenses should be based on specific plans and programs. Past experience, adjusted for anticipated changes in management policy and general economic conditions is helpful. Because most administrative expenses are fixed an analysis o the historical record will often provide a sound basis for budgeting. (Welsch, Hilton and Gordon, 1999:317)

### **2.17 Capital Expenditure Budget**

Capital budget is the firm's formal plan for the expenditure of the money to purchase fixed assets. "A capital expenditure is the use of funds to obtain operational asset that will (a) help to earn future revenues or (b) reduce future costs. Capital expenditure is investments because they require commitment of resources today to receive higher economic benefits (i.e. profit) in the future. Capital investments becomes expense in the

future as they are related goods and services being used to earn higher future revenues or to achieve future cost saving.

It is an internal corporate document that lists the accepted investment projects for given fiscal period. “Capital budgeting involves the generation of investment proposals: the evaluation of cash flows; the selection of projects based upon acceptance criterion and finally the continual revaluation of investment projects after their acceptance.”(Van Horne, (2000:48). It may be defined as the decision making process by which firms evaluates the purchase of major fixed assets, including building, machinery and equipment. It is the part of the firm’s formal planning process for the acquisition and investment of capital.

“Capital budgeting is the process of planning and controlling the strategic (long term) and tactical (short term) expenditures for expansion and contraction of investments in operating (fixed) assets.” (Welsch, Hilton and Gordon, 1999:394)

Capital projects are those that are expected to generate return for more than one year. Capital budgeting refers to the process of planning capital projects, raising funds and efficiently allocating resources to those capital projects.

Capital expenses are made in order to reduce the cost, increase output, expand into new products or market and/or meet government regulations. In general, capital expenditures are made in unit of the rate of return or cost dollar invested equals the marginal cost of capital.

For planning and controlling capital expenditures Welsh, Hilton and Gordon have mentioned the following seven processes:

1. Identify and generate capital additions redetect and other needs.
2. Develop and refine capital additional proposals.
3. Analyze and evaluate all capital additions proposal.

4. Make capital expenditures decisions to accept the best alternatives and assignments of project designations to selected alternatives.
5. Develop the capital expenditure budgets.
6. Established control of capital expenditures during the budget year by using periodic and special performance reports by responsibility centers.
7. Conduct post completion audits and follow up evaluations of the actual results from capital expenditures in periods after completion. (Welsch, Hilton and Gordon, 1999:394)

Normally, annual capital expenditures budget should be developed by time periods and responsibility centers. Capital budgeting is process of determining which capital investment will be undertaken. There are three stages of capital budgeting proposal generation, analysis and implementation. Capital budgeting is the analysis of proposal of long term investments; it is the decision making process that determines the type of plant and equipment a firm will own, how much be invested in such assets and when the expenditures will be made.

Capital expenditure involve the huge amount of resources and it is the long term commitment of management therefore while planning such expenditure serious consideration should be given and such planning should sustain in appropriate process.

### **2.17.1 Capital expenditure decision**

The selection of best alternative from the competing capital expenditures alternatives or projects by the management is capital expenditure decision. While making such decisions focus should be given mainly in two points. First is to select the investment decisions which should best alternative based in their economic worth and second is to determine the financing decisions which should be the amounts and sources of funds needed to pay for the selected alternatives.” The essence of capital investment

analysis is in comparing the benefits that accrue over the period of time with the amount invested. This comparison is made with a view to judge or not the benefits are at least as high as the amount invested (Van Horne, James C, 2000:48)

There are several techniques used to measure the capital investment. Welsch, Hilton and Gordon have suggested the following two approaches to measure such decisions.

#### Discounted cash flow methods

There are mainly two types of this method

#### B. Net present value (NPV) method

This method will compare the present value of net inflows with present value of net cash cost of capital expenditure project: the amount difference between these two present value amounts is called Net Present Value. The net cash inflows are discounted to present value by using a target of minimum rate. To calculate the NPV following formula will be used:

$$\frac{AT}{(1+K)^t}$$

Where,

K= cost of capital or targeted rate of return

T=No. of years

C= Initial cash outlays

A= Expected cash inflows

#### C. Internal rate of return (IRR) method

The IRR is the rate which will discount all the future net cash inflows so their sum will be equal to the initial outflows of the investment project. Following formula will be used to calculate the IRR:

$$A = \frac{A_1}{1+r} + \frac{A_2}{(1+r)^2} + \frac{A_3}{(1+r)^3} + \dots + \frac{A_n}{(1+r)^n}$$

Shortcut and simple methods

There are two types of method

A. The payback period (PBP) method

This method will compute the payback period, which is the number of the years that is it takes to recoup a cash investment from the annual net cash inflows from the investment. To calculate the PBP, following will be used

**Pay back periods in year** =  $\frac{\text{Net cash investment}}{\text{Annual net cash inflows or net cash saving}}$ .

B. the average rate of return (ARR) on total investment method

This method represents the ratio of the average annual profits to the investment in projects. The following formula will be used for this:

**Average cash return in total cash investment** =  $\frac{\text{Average annual net cash inflow}}{\text{Cash outflow of the investment}}$

After analyzing the above stated methods to measure capital investment, the following decision criteria can be summarized as follows:

<u>Method</u>	<u>Accept project when</u>
NPV	Higher the NPV
IRR	Higher the IRR
PBP	Lower the PBP
ARR	Higher the ARR

(Welsch,Hilton and Gordon,1999)

## 2.18 Cash Budget

“The cash budget is the forecast of expected cash receipt and payments for the future period” (Ratnam, 1994:275). A cash budget shows the planned cash inflows, outflows and ending position by interim periods for specific time span. A cash budget basically includes two parts 1. The planed cash receipt (inflows) and 2. The planned cash disbursements (outflows). Planning cash inflows and outflows gives the planned beginning and ending cash position for the budget period and this will indicate 1) the need for financing probable cash deficits and 2) the need for investment planning to put excess cash to profitable use. The primary purposes of cash budget are to:

1. Give the portable cash position at the end of the each period as the result of planned operations.
2. Identify the cash excesses or shortages by time periods.
3. Establish the need for financing and /or the availability of idle cash for investment.
4. Coordinate cash with a. total working capital, b. sales revenue, c. expenses, d. investments, and e. liabilities

5. Establish the sound basis for continuous monitoring of the cash position.  
(Welsch, Hilton and Gordon, 1999:434)

The planning and controlling of cash inflows and cash outflows is important and the cash budgeting is the effective way for this. Cash budget is based on other functional budgets. Mainly cash budget of three parts i.e. a) estimate of cash receipts b) estimate of cash disbursement and c) cash balance each month of budget period. There are mainly approaches of developing the cash receipts and disbursements approach and the other financial accounting approach. (Welsch, Hilton and Gordon, 1999:435)

The cash position of business enterprise can be presented in a table as the following:

<b>Item</b>	<b>January</b>	<b>February</b>	<b>March</b>	<b>Total</b>
A. Beginning balance				
B. Cash Receipts Accounts receivables Notes Receivable Loans Royalties and Commissions Investment interest New capital issues Disposal of assets] Other sources Cash sales -----				
B. Total Receipts				
C. Total cash available				
D. Cash Disbursements Cash purchase Accounts payable Wages Salaries and commission Royalties Advertising Rent, rates and taxes Dividends and interest New assets Loan redemption Other expenses				
D. Total disbursement				
E. Surplus				
F. Desired closing balance				
G. Additional cash balance required to maintain cash balance.				
Surplus funds available for investment				

## **2.19 Advertising and Promotional Expenses Budget**

Development of advertising and promotional expenses budget is a complex endeavor that should involve most of the marketing managers. It is commonly established position of advertising managers. The advertising may vary from international program to local advertising on a small scale. There are certain types of expenditures in business that are planned and controlled in the basis of definite appropriation for specific time periods. Research costs and advertising costs are of such nature that some justification for unlimited expenditures might be forthcoming. Therefore top management should require that such activities to be specifically programmed and planned and that the attendant costs be carefully established various method appropriations. The more commonly used methods can be categorized as follows : a. Arbitrary appropriation, b. All available funds, c. Competitive party, d. Percentage of sales, e. Fixes sum per unit, f. Previous years profit g. Return on investment, and h. the task method.

The advertising and promotional expenses budget should be the direct responsibility of the marketing executives. Specially, the advertising manager for it is inconceivable that inaccurate sales budget could be developed without at the same time developing detailed promotional plans. (Welsch, Hilton and Gordon, 1999:345)

## **2.20 Other Sub-Budget Required for Completion of Profit Plan**

The development of an annual profit plan is not only preparing the various functional budgets as stated above but also needs to prepare the planned income statement and also the planned balance sheet. These statements are the summary and the combination of all functional budgets. After the preparation of all functional budgets, there should be necessary to prepare the following statements to complete the annual profit plan of business enterprise

1. Planned statement of cost of goods manufactured.

2. Planned statement of cost of goods sold.
3. Planned income statement.
4. Planned balance sheet.

This is the ending point of a profit plan of the business enterprise when these statements are assembled with other functional budget. (Welsch, Hilton and Gordon, 1999:395)

### **2.21 Implementation of Profit Plan**

The final test of whether the effort and cost in developing a profit plan are worthwhile is its usefulness to managements. The plan should be developed with the conviction that enterprise is going to meet or exceed all major objectives participation enhances communication. If this principle is to be effective, the various executives and the supervisors should have a clear understanding of their responsibilities. The copies of the complete profit plan should be prepared and distributed to the members of the executive management. Normally, distribution of the complete profit plans should be limited to vice-president and the heads of certain staff group.

After the distribution of the profit plan, a series of profit plan conference should be held. The top executives discuss comprehensively the plans, expectation and steps in implementation. At this level, the importance of action flexibility and continuous control may well be emphasized. In essence, each manager has to realize that the budget is a tool of their use.

Performance must be measured and reported to management. Execution of the plan is assured through control. Procedures must be established so that accomplishment or failure is immediately known. On the basis, action can be taken to correct or minimize any undesirable effects. Short term performance reporting is essential.

## 2.22 Performance Evaluation

Evaluation of performance and reporting it to connected authorities are necessary aspects of comprehensive planning and control program. Performance reporting for internal management use is an important part of a comprehensive profit planning and control system. They are usually prepared on monthly basis and follow a standardized format from period to period reports which are designed to pinpoint both efficient and inefficient performance by comparing budgeted and actual objectives of the firm.

to indicate the extensive reporting requirements a business must fulfill and focus on performance reporting , the following broad classification of reports is presented and briefly explained:

### 1. External reporting

These are reports to government agencies, regularity commissions, creditors, investigative agencies and other group external to the active management. Frequently, these reports are extensive and constitute a significant portion of the overall reporting activities of the business.

### 2. Reports of owner

This is the traditional annual report to the owners and other special reports prepared for the owner. These reports by and large are based on generally accepted accounting principles and generally report data that have been subject to an audit by independently.

### 3. Internal report

These confidential reports are prepared within the company the company for internal use only. Thy do not have to meet the needs of external groups. Internal report is subdivided into three different classifications.

- a. Statistical reports.
- b. Special reports
- c. Performance reports

#### 4. Performance reports

These reports are usually prepared on monthly basis and follow a standardized format from period to period. They should be composed of carefully selected series of data related to each responsible center. These are designed to facilitate internal control by management.

Essential features of performance report (i.e. performance report should be):

1. Tailored to the organizational structure controllability
2. Designed to implement the management by exception principle
3. Repetitive to the requirements to the primary users
4. Adapted to the requirements to the primary users
5. Simple understandable and report only essential information
6. Accurate and designed to pinpoint significant distinctions
7. Prepared and presented promptly
8. Constructive in time.

Performance report must be helpful to distinguish between controllable and non controllable items. The actual results are compared with plans; the management analyses its objectives and standards and the difference. Careful attention should be given on formant while designing the performance report.

Another important aspect of performance report is to minimize the time gap between the decision and report. The company had to suffer a real loss if an

unfavorable situation arises before correction. Management follow up procedure are also equally important. As the report indicates the favorable and unfavorable variance between planned and actual performance, immediate correction should be made. Follow up procedure should analyze both satisfactory and unsatisfactory conditions and corrective decisions should be made.

The main purpose of performance reports is to show variances. Such variances should be expressed in amounts as well as percentage of the plan of budgeted amount. Statistical control units should also be developed to determine the significance of variances. (Welsch, Hilton and Gordon, 1999:434)

### **2.23 Analysis of Budget Variance**

Variance is the deviation between budgeted of planned goals and actual results. As performance report shows such variances, the next step is to analyze such variances and determine the underlying causes for managerial planning and control purpose. Variance analysis is the determination of the reasons for a reported variance whether favorable or unfavorable. The difference between standard cost and actual cost is variance. It is basic features of performance reports to indicate the variances between actual results and planned and budgeted goals. If a variance is significant, a careful management study should be made to determine the underlying causes. There are numerous ways to study and investigate variances to determine the underlying causes.

Some of the primary approaches are the following:

- ❖ Conferences with responsibility center managers and supervisors and other employees in the particular responsibility center involved.
- ❖ Analysis of the work situation including the flow of the work, coordination of activities, effectiveness of supervision other prevailing circumstances.
- ❖ Direct observation.

- ❖ On the spot investigation by line managers.
- ❖ internal audit
- ❖ Special studies.
- ❖ Investigation by staff groups.
- ❖ Variance analysis.

Variance analysis involves a mathematical analysis of two sets of data in order to gain insight including causes of variance. One amount is treated as the base standard as reference point. Variance analysis has wide application in financial reporting. (Welsch, Hilton and Gordon, 1999:445)

Variances are analyzed in the following areas:

1. Raw material variance
2. Labor variance
3. Overhead variance
4. Sales variance
5. Profit variance.

For the analysis of variance, following steps are followed

1. Setting standards.
2. Measurement of performance.
3. Analyzing Variances.
4. Taking corrective action.

## **2.24 Basic Assumption and Limitation of Profit Plan**

Profit planning system is most common in larger business organization to serve management. Still the usefulness of profit planning to carry small business could have been circumvented by an early attempt to qualify the dreams of head strong but sloppy thinking entrepreneurs who never direct the uncertainties of their venture.

But there are so many assumption of using profit-planning programs. Firstly the basic plans of a business must be measured in the terms of money, if thee is to be any assurance that money will be available for the needs of a business.

Secondly, it is possible to plan for the business in a comprehensive way, coordinating every aspects of business with every other aspect to establish optimum profit goals. Thirdly, profit planning is preplanning not merely what to do if thins without as forecasted, but also what to do if things workout differently from the forecast.

“Because effective budgeting requires coordinate planning, it is essential that all persons participating in the building of the budget are planning towards the same objectives and are contemplating the same company, industry and general economic conditions, this can be accomplished by issuing a statement of basic assumption prior to start of budgeting system.”

Aside from the above arguments, the following critical features are always present;

- ❖ The profit plan is based on estimates and it may not be accurate.
- ❖ A profit planning and control program may be continually adapted to fit changing circumstances of the business enterprise.
- ❖ Execution of profit plan will not occur automatically.
- ❖ The profit plan will not take the place of management and administration.

(Welsch, Hilton and Gordon, 1999:265)

## **2.25 Review of Related Studies**

Only a few research works have been made in the area of profit planning and control in Nepalese manufacturing public enterprise. Due to their limitations, the available research works are not in depth and details in focusing the profit planning and control as a model of planning and control. A few dissertations that have been submitted in the related topic are reviewed here in brief.

**Khagendra Prasad Ojha, 2000**, conducted a research on 'Profit planning in manufacturing public enterprises (a comparative study on Royal Drugs Limited and Herbs Production and processing Company limited)'. He has pointed out some features and problems of profit planning in context of Nepalese manufacturing public enterprise with special reference to RDL and HPPCL .this research has mainly centered with the practice of profit planning and its effectiveness in RDL and HPPCL. The main objectives of this research were:

- ) To highlight the current practice of PPC and its effectiveness in Nepalese PEs.
- ) To analyze the various functional budgets which are adopted in these enterprise.
- ) To evaluate the variance between achieved targets and actual targets of the enterprise.
- ) To draw a picture of PPC process adopted in these two enterprises with theoretical prescription.

The time period covered by this research was five-years from fiscal year 056/57 to 059/60. The data and other necessary information were collected by using secondary as well as primary sources of data. Remarkable findings of his research are:

- ) Inadequate planning of profits due to lack of skilled planners.
- ) Inadequate authority and responsibility to planning department.
- ) Failure in achievements due to inadequate evaluation of internal and external variables.
- ) Failure due to inadequate forecasting system.
- ) Lack of entrepreneurship and commercial concepts in overall operation of the enterprise.

He has summarized his findings by stating plans are formulated on traditional ad hoc basis due to lack of budgeting experts and skilled planners. The pricing system of Nepalese PEs is not scientific. They adopt traditional pricing methods. Usually cost plus pricing method is applied to determine price. Certain products are priced below cost as per Nepal government circular. The remarkable recommendations in his research are:

- ) It seems necessary to develop , implement and improve the process of profit planning
- ) System of periodical performance reports should be strictly followed.
- ) A systematic approach to comprehensive PPC should be adopted. (Ojha, 1995)

**Prakash Bahadur Chanda, 1999**, made a research on ‘Profit Planning in Herbs Production and Processing Company Limited’. He has tried to point out some features and problems of profit planning and control in the context of Nepalese manufacturing public enterprise.

The general objectives of this research study was to apprise HPPCL appropriately for the application of comprehensive profit planning system and specific aims were as follows:

- ) To identify the profit planning process adopted by HPPCL
- ) To assess the BEP analysis of HPPCL.
- ) To recommend the steps to be taken to improve the profit planning process.

The time period covered by this study was five years from fiscal year 055/56 to 058/59. He collected the data and other necessary information using secondary as well as primary sources of data.

He has summarized his findings by stating with problems in evaluating market variables and in formulation and implementation due to lack of planning experts. The major findings of his research are:

- ) Inadequate evaluation of relevant international market variables.
- ) Inadequate planning due to the lack of planning experts.
- ) Inadequate technical manpower.
- ) Inadequate authority and responsibility to planning department.
- ) Unrealistic sales forecasts.
- ) More bureaucratic formalities of HMG on business lead delay in exports.

- ) The top level executives are only involved in planning and decision making and lower level participation is not implemented.
- ) No proper management to supply the herbs and herbal products in domestic and international market.
- ) The company has no proper practice of segregation of cost in fixed and variable.
- ) The company has been unable to get break-even point. It is suffering from the problem of loss.
- ) Financial position of the company is not good.

He has summarized his study concluding that the public enterprise is not clear in broad objective and they have not commercial entrepreneurs. Furthermore, HPPCL have failed to evaluate internal and external variables to apply comprehensive PPC program. The remarkable recommendations in his research are:

- ) HPPCL should develop to broad company's objectives.
- ) Government intervention should not be made for functional aspect of company. Management should be given full authority, responsibility and accountability for routine and major operation.
- ) It seems necessary to develop, implement and improve the process of profit planning from the very beginning to the end.
- ) System of periodical performance reports should be strictly followed.
- ) Finally, a systematic approach should be made towards comprehensive profit planning and control program. This can be considerably contributed to increase the profitability of the company. ( Chanda, 1999)

**Prem Prasad Acharya, 2003**, conducted the research on 'Profit Planning in Manufacturing Public Enterprise (a case study of HPPCL). He has tried to shoe profit plans, practice and effectiveness of comprehensive profit planning and control system of HPPCL and review the picture and efficiency of manufacturing establishment with special attention to HPPCL. The period covered by this research war five years from fiscal year 059/60 to 062/63. The major findings of his study were:

- ) Lack of clear cut and result oriented objectives.
- ) Excessive fixed cost and variable cost.
- ) Over staffing.
- ) Inadequate planning of profit due to lack of skilled planners.
- ) The company has no proper practice of segregating cost in fixed and variable cost.
- ) Excessive amount of inventory.
- ) Lack of technical expert.
- ) Lack of evaluation of relevant international market variables.
- ) HPPCL cannot meet BEP so it is running in loss.
- ) Lack of participatory management.
- ) There is no systematic and effective control mechanism to reduce cost.

He has suggested various recommendations to improve the performance of HPPCL.

Among these the remarkable recommendations are as follows:

- ) The objective of the company should be clearly defined.
- ) The company should be operated on commercial basis.
- ) The company should have in depth analysis of significant strength and weakness. It should try to overcome its weakness by using the strength.
- ) Nepal government intervention should not be made for functional aspect of company.
- ) Fundamentals and process of process of profit planning and control should consider while preparing budgets.
- ) Sales, production, direct labor budgets should be prepared according to responsibility centers, products and interim time period.
- ) Material budget should be prepared by product, material and interim time period.
- ) Expense should be classified as controllable Vs non-controllable and fixed vs variable.

- ) Cost control and evaluation program should be introduced to control the high overhead cost.
- ) The company should develop the practice of analyzing the variance and performance report.
- ) To adopt systematic approach to comprehensive profit planning and control, planning experts should be hired and existing planning should be trained. (Acharya , 2000)

**Keshab Bahadur K.C., 2000**, submitted his research work on profit planning in Herbs Production and Processing Company Limited to the central department of management, T.U. the basic objective of his study was to highlight the practice of profit planning and effectiveness in HPPCL. The specified objectives of his study are:

- ) To examine the present profit planning practice adopted by HPPCL
- ) To observe the HPPCL's profit planning on the basis of overall managerial budgeting.
- ) To analyze the difference between budgeted and actual achievement of HPPCL.
- ) To point out suitable suggestion and recommendation.

He has pointed out various findings based on the analysis of data and information. The major findings of his research are:

- ) Internal and external variables providing opportunities, threats and weaknesses are not identified.
- ) Specific goals and objectives are not conveyed to lower level of staffs.
- ) There is no cost classification system. Overheads are not classified systematically and it creates problem to analyze its expenses properly.
- ) Absence of skilled and purely academic manpower in budgeting section of the company.
- ) The company has no proper marketing strategy.
- ) Alternatives for making channel, pricing and promotion are not considered.

He has mentioned various recommendations to improve the profit planning system of HPPCL. The major recommendations of him are as follows:

- ) HPPCL should be operated on commercial basis and it should make policy about research and development, factory productivity, capacity utilization and mainly cost control.
- ) HPPCL should develop the direct labor budgets for the annual profit plan by responsibility centers, interim time periods and products.
- ) There should be continuous flow of information among various levels of management.
- ) HPPCL should prepare material requirement budget and raw material purchase budget separately.
- ) Separation of costing system is strongly suggested i.e. fixed, variable, controllable, uncontrollable, direct, indirect etc.
- ) Capital expenditure should be planned in detail.
- ) HPPCL should adopt systematic practice of cash budget.
- ) Cost volume profit relationship should be considered while developing sales and pricing strategy.
- ) System of periodical performance reports should be strictly followed to conscious about poor performance and to take corrective action timely. (K.C., 2000)

**Bhabiswar Pandey, 1999**, submitted his research work on 'Profit planning in Nepalese manufacturing public company (A case study of Butwal Sinning Mills Limited). The main objectives of the study were to examine the effectiveness of profit planning system in BSML. The period covered by the study is five years from fiscal year 2049/50 to 053/54. The major findings of his study are as follows:

- ) The company has no planning decision. It has no skilled and expert planners as well.
- ) There is no detail planning of manpower and systematic approach of labor planning.

- ) The company has no proper practice to segregating cost into fixed, variable and semi variable etc.
- ) Sales and production are made on ad hoc basis.
- ) The company has no any inventory policy. The finished goods inventory level of the BSML has been fluctuating year to year.
- ) The company has no proper practice of planning various expenses.

He has mentioned various recommendations to improve the profit planning system or BSML. The major recommendations are:

- ) BSML should have clear about its objectives and to achieve the basic objectives and it has to define its main objectives in annual goal
- ) The company should consider its product line to improve its profit.
- ) It should manage the inventory properly.
- ) The company should improve quality of its products.
- ) Profit planning manuals should be communicated from top to bottom levels.
- ) Trained and qualified manpower should be hired for planning and budgeting.
- ) The cost should be classified properly to manage cost control.(Pandey , Bhabiswar , 1999)

**Anoja Shakya, 2063**, submitted her research work on PPC of two joint venture banks, Himalayan Bank Limited and Everest Bank Limited. The main objectives of the study were to evaluate the functional plan formulated by the both banks. The period covered by the study is five years from five years 2054/55 to 2061/62. The major findings of here are as follows:

- ) Profitability position is unsatisfactory in HBL than EBL.
- ) Excessive expense
- ) Poor capacity of HBL than that of EBL.
- ) Higher liquidity ratio
- ) Lack of using trained personnel.

- ) No concentration to mobilize their deposit in production sectors.
- ) No emphasis on planning, research and development for the proper planning and controlling purpose.

She has suggested various recommendations to improve the performance of HBL and EBL. The major recommendations are as follows:

- ) HBL and EBL should open their branches in other rural area and cities, especially HBL in order to find profitable opportunities.
- ) The both banks should invest all the excess balance in income generation sectors.
- ) Both banks should control their expenses which are necessary and they must formulate the strategy to control their expense.
- ) They should search for the profitable sectors for investment and utilization of the resources.
- ) They should minimize their cash deposit in Nepal Rastra Bank.
- ) They should minimize the level of balance need to open an account for small investors.
- ) Emphasis should be given on planning, research and development for the proper planning and controlling purpose.(Shakya, 2063)

### **2.26 Research Gaps**

All the previous research studies mentioned above and the other consulted through out this study about profit planning and control system are basically related to the application of profit planning system based on past period of time. This study is a bit different from previous studies. This study attempts to present planning in a real sense of plan that necessarily takes future period of time. Measuring the effectiveness of planning may be viewed as the concept of control. Thus, this study attempts to apply future period of time for real concept of planning and the past periods of time only for control purpose. This research attempts to take the appropriate time period in the real sense of planning and control. This study attempts to indicate the real role of budgets for the formulation and implementation of profit planning system.

## **Chapter III**

### **Research Methodology**

#### **3.1 Introduction**

This research study attempts to examine the application of PPC practice in HPPCL, Nepal. PPC is one of the most important managerial devices that plays a vital role for effective formulation and implementation of different annual plans in an organization. PPC system requires the effective coordination between various functional budgets in the organization. Thus, this research attempts to show the relationship between these various functional budgets, their achievement, and their effective application for achieving the goals of the organization. Besides, this study intends to show the effectiveness of profit planning in the enterprise. It requires an appropriate research methodology to follow, which this chapter presents in the paragraphs that follow.

#### **3.2 Research Design**

This study has attempted to analyze and examine the application of various budgets as components of the profit planning and control in a public sector enterprise. Preparation of budgets and their implementation involve the participation of all levels of the organization. It has basically sought to analyze deviation of the actual and budgeted performance for the period under study. Therefore, the research design of the study has been analytical.

#### **3.3 Unit of Study**

The study uses a public sector manufacturing enterprise as a unit of study to assess the application of PPC. The unit is Herbal Processing and Products Company Ltd.

### **3.4 Period Covered**

In the life of an enterprise, there may be ups in some years and downs in some other years in its performance. In order to have a fair insight into the trends of its performance, therefore, data for a longer period are desirable. Due to the limitations of the researcher, however, summarized data of five years have been gathered for the purpose of the study. Therefore, the study has used the data of HPPCL from fiscal years 2063/064 to fiscal year 2067/68.

### **3.5 Nature and Sources of Data**

For the purpose of study, Secondary data have been used.

- a. Secondary Data: In the study, secondary data have been used. The sources of secondary data used in the study are company's annual report, directors' report, audit report, journals, book-let, newspaper and magazine, dissertations, books, etc.

### **3.6 Data Gathering/Collection Procedure**

The data required for the study have been collected directly from HPPCL. Questionnaire drawn upon the various levels of employees of the company was administered to the employees to find out the information and crosschecks were made to see the reliability of the information. The questionnaire was distributed to different various levels of employee of HPPCL.

The study used larger percentage of the secondary data than the primary data. As per the requirement of the study, accounting information and the like were gathered as secondary data. The company is the major source of secondary data. Secondary data used in the study were gathered from the visit of the head office of HPPCL, different libraries in Kathmandu, Public Enterprise Cell in the Ministry of Finance, etc.

### **3.7 Techniques of Data Presentation and Analysis**

The data after presentation is interpreted as to best suit the interest of the reader or to provide the theoretical insight about the data behavior. While developing thesis extreme care is taken to present it in the simple flow of thought. The information needed for research is collected through varying means as questionnaire, interview and observations. As this is comparative study upon actual and budgeted data, performance report is considered.

For the analysis of the data, various financial and statistical tools have been used.

**Ratio Analysis:** To analyze the relation and pattern of the various expenses, income, level of different costs and for calculating margins, ratio analysis has been conducted.

**Statistical Methods:** For analyzing the relation of the obtained data, correlation method has been used to see the close relationship between variables and regression line are fitted. The variance, deviation and average are used for seeing the consistency, variability and stability of the data.

## **Chapter IV**

### **Data Presentation and Analysis**

#### **4.1 Introduction**

Public enterprises are established as an instrument of socio economic development of the country. It is now widely accepted that the public enterprises have to be run in a profitable so that they cannot sustain themselves but also achieve growth and deliver more and more to the general public. However, majority of the Nepalese public enterprises are neither sustaining themselves nor delivering well to the public as they suffer heavy losses due to several reasons. Therefore, it is a pressing need to bring them back to the right track by identifying the causes of their poor performance and taking corrective measures for their improvement. This study is a step towards that direction. This study attempts to see how profit planning and control, a newly developed concept that is used extensively in the literature of business, can make positive impact on the performance of these enterprises.

The major problem of formulating and implementing profit plan in public enterprises is conflict in their broad objectives, the other problems rise during the implementation of profit planning and control program.

In Nepal, public enterprises are established with the explicit objective of mobilizing resources and earning reasonable profits necessary for development of the country. Government has issued instructions to the public enterprise to earn a minimum return on the capital employed. To optimize the enterprise profit by improving the present situation, profit planning and control system may be applied as a tool that is used by the management in planning the future courses of action and controlling the actual performance. An effective mechanism of financial management and control can be built up on sound comprehensive budgeting system.

Thus the main purpose of this study is to have an insight into the current practice of formulation and implementation of the profit planning and control program in the context of Nepalese manufacturing public enterprises. For this reason, Herbs Production and Processing Company Limited (HPPCL) have been conveniently selected for the study and data analysis purpose. To accomplish the specified objective, this chapter will present and analyze the different plans and aspects of PPC with reference to HPPCL.

HPPCL has practice of preparing tentative budgets for both short term and long-term periods but has no practice of formulating and implementing comprehensive profit planning and control. Though it prepares strange long range budgets, the present study doesn't make analysis of it in detail because of the resource constraint. Therefore, the study is mainly focused on tactical short-range profit plan of HPPCL. However, the sales, production and other related figures of previous years are also presented and analyzed to know the overall economic and financial trend and to estimate the possible future position of HPPCL. For this purpose, the study covers the period of five years 2063/64 to 2067/68.

The tactical short-range profit plan is analyzed by taking relevant figures and various functional budgets of one fiscal year because the process of formulation, implementation and evaluation of profit planning and control program may be the same for every year and repeated each year. For this reason, fiscal year 2067/68 has been taken as a representative year to highlight the tactical short-range profit plan of HPPCL. Various functional budget of fiscal year 2067/68 are analyzed in detail.

This study deserves to recommend an appropriate comprehensive profit plan model for immediate and correction in profit planning and control system of HPPCL. It also points out the reason behind the deviation between budget and actual results.

## **4.2 Profit Planning and Control at HPPCL**

The profit planning and control process involves the sequential phase that management must perform from identification and evaluation of environmental variables for the business to control, corrective action and planning. The process necessarily integrates planning, leading and controlling as discussed earlier.

Herbs Production and Processing Company Limited (HPPCL) was established in 12<sup>th</sup> Poush, 2038 B.S. It is a manufacturing public enterprise. Introduction to HPPCL has already been discussed in the first chapter. The company has been practicing planning the general program and is preparing budget since its establishment. Generally, the work of preparing budget and program starts prior to six months of every fiscal year. For preparation of budget and program, the company has a planning department. Finally, Board of Directions approves the budget and program. The board is the highest authority of the company. Since the company had no practice of formulating appropriate PPC program, this study tries to summaries its profit planning and control model as depicted in this format.

The company had no practice of formulating profit plan. For the management planning and control purpose, a tentative target is set. The target is included in annual program prior to the start of each fiscal year. Likewise, the actual achievement is compared to that tentative target which is called “*Pragati Bibaran*” (progress report). The progress report is prepared only for the purpose of presenting to the line ministry and final audit rather than for internal control purpose. The related data are included in appendixes.

### **4.2.1 Sales Budget, Planning and Control**

The sales planning is the foundation for budgeting that is essential for profit planning and control. It is a first plan or budget to be prepared. All other planning is based on it. Sales are the main source of revenues. The sales not only generate revenues but also incur selling cost. For this reason, a comprehensive sale planning includes both revenues and selling cost components. The sales planning is a forecast of total sale. It is classified

according to group of products, salesperson, and geographical locations. It is also conserved with estimate of the cost of selling and distribution of goods.

The overall responsibility of preparing sales budget is upon planning director of HPPCL. It has generally four alternative distribution channels for different products. These are:

Producer-Customer

Producer – Retailer-Customer

Producer- Wholesaler-Retailer-Customer

Producer-Agent-Wholesaler-Retailer-Customer

The company produces and exports different medicinal and aromatic plants in both processed and raw form. The company has been exporting its products to France, Germany, Italy ,U.K. , Australia , Spain, India, Pakistan, U.S.A. etc. the company sells its products against cash and letter of credit therefore they have no problem of credit collection for recovering credit sale.

Sales planning are well defined field that has less diversity in budgeted and actual sales. Diversity leads to the poor performance regarding management and others. For analyzing sales firstly, we have to analyze the budgeted and actual sales. For this, the following schedule presents the annual performance report of sales in total from fiscal year 2063/64 to 2067/68.

**Table 1: Annual Sales Performance, 2063/64-2067/68**

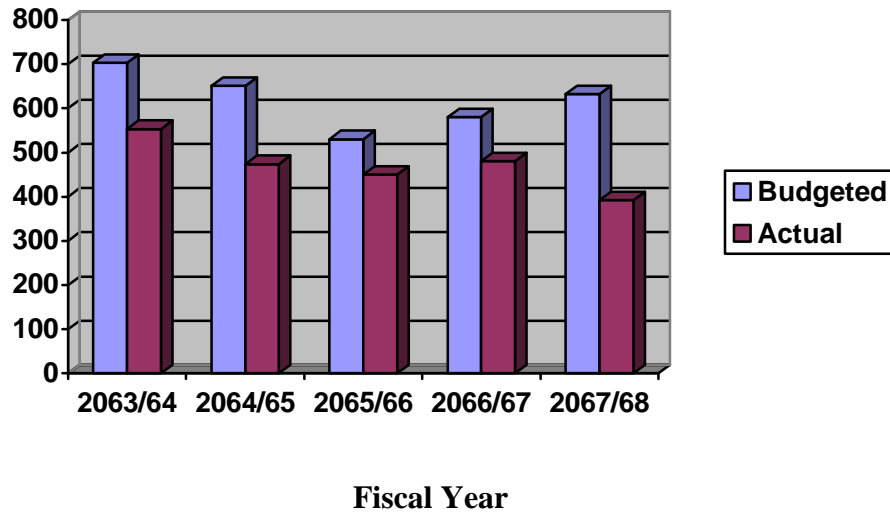
Rs. in '00,000'

<b>Fiscal year</b>	<b>Budgeted Sales (Rs.)</b>	<b>Actual sales (Rs.)</b>	<b>Variance in amount (Rs.)</b>	<b>Variance in %</b>
2063/64	703	392	(311)	(44.23)
2064/65	651	480	(171)	(26.26)
2065/66	530	450	(80)	(15.09)
2066/67	580	474	(106)	(18.27)
2067/68	632	553	(79)	(12.5)

3Source: Annual Reports of HPPCL, 2063/64-2067/68

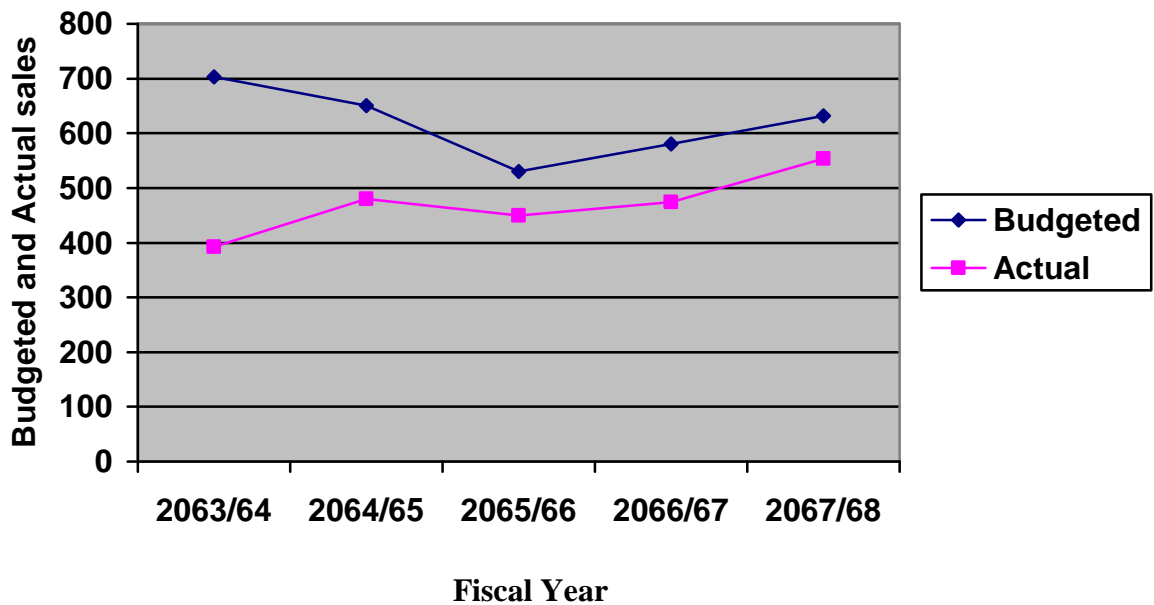
The above table reveals that there is no systematic and scientific sales plan because there is no progress in sales achievement though targeted sales are increasing year by year. It is

obvious that performance of planning section of HPPCL is very poor and it prepares the sales plan on haphazard basis. Budgets are set only on the assumption of management. Diagrammatic presentation of budgeted sales and actual sales are depicted in Figure-1.



**Figure 1: Annual Budgeted and Actual Sales of HPPCL**

Actual achievement of budgeted sales has also been presented in a graph (Figure 2) to show the clear view of the gap between the budget and the actual achievement of sales.



**Figure 2: Actual Achievement of Budgeted Sales**

Figure 1 and Figure 2 show that the gap between budgeted and actual sales is very high and the actual sales achievement is always below than budgeted sales in every fiscal year. Statistical tools such as arithmetic mean, standard deviation, coefficient of variation, coefficient of correlation and probable error have been used to find out the nature of variability of budgeted and actual sales of different years. Table 2 exhibits arithmetic mean, standard deviation, and coefficient of variation, coefficient of correlation and probable error of the budgeted and actual sales

**Table 2: Arithmetic Mean, Standard Deviation, Coefficients of Variation and Correlation, and Probable Error of Budgeted sales, X and Actual Sales, Y**

Rs. in '00,000'

Year	X	$x=X-\bar{X}$	$x^2$	Y	$y=Y-\bar{Y}$	$y^2$	xy
2063/64	703	84	7056	392	(78)	6084	(6552)
2064/65	651	32	1024	480	10	100	320
2065/66	530	(89)	7921	450	(20)	400	1780
2066/67	580	(39)	1521	474	4	16	(156)
2067/68	632	13	169	553	83	6889	1079
	3096		17691	2349		13489	(3529)

### Calculation of Mean, S.D. and Coefficient of Variation

#### For Budgeted Sales,

$$\begin{aligned}
 1. \text{ Mean (X)} &= \frac{\sum X}{n} \\
 &= \frac{3096}{5} \\
 &= 619
 \end{aligned}$$

$$2. \text{ Standard deviation ( )} = \sqrt{\frac{\sum \phi x^2}{n}}$$

$$= \sqrt{\frac{17691}{5}}$$

$$= 59.48$$

$$\begin{aligned} 3. \text{ Coefficient of Variation (C.V.)} &= \frac{u}{X} * 100 \\ &= \frac{59.48}{619} * 100 \\ &= 9.60\% \end{aligned}$$

**For Actual Sales,**

$$\begin{aligned} 1. \text{ Mean (Y)} &= Y/n \\ &= 2349/5 \\ &= 470 \end{aligned}$$

$$\begin{aligned} 2. \text{ Standard deviation ( )} &= \sqrt{\frac{\sum y^2}{n}} \\ &= \sqrt{\frac{13489}{5}} \\ &= 52 \end{aligned}$$

$$\begin{aligned} 3. \text{ Coefficient of Variation (C.V.)} &= \frac{u}{Y} * 100 \\ &= \frac{52}{470} * 100 \\ &= 11.06\% \end{aligned}$$

**Calculation of Correlation Coefficient and Probable Error**

Correlation Coefficient

$$\begin{aligned} 'r' &= \frac{\sum xy}{\sqrt{\sum x^2 * \sum y^2}} \\ &= \frac{23529}{\sqrt{17691 * 13489}} \end{aligned}$$

$$= \frac{-3529}{15448}$$

$$= -0.22$$

$$\text{P.E} = 0.6745 * \frac{1 Z r^2}{\sqrt{n}}$$

$$= 0.6745 * \frac{1 Z (Z.22)^2}{\sqrt{5}}$$

$$= 0.287$$

According to the above analysis all actual sales is less than budgeted. Variation in budgeted and actual sales is wide, as standard deviation also shows the same. The above analysis shows that actual sales are more variable than budgeted sales. The coefficient of variation of actual sales is higher than budgeted sales. A distribution with smaller C.V. is said to be more homogenous or less variable. The series with greater C.V. is said to be heterogeneous or more variable. The above result shows that actual sales fluctuate more than budgeted sales. Budgeted production is less variable than the actual sale as it has lower C.V. than the actual sale.

To find the correlation between the budgeted sales and actual sales, Karl Parson's coefficient of correlation is determined. For the purpose of calculation 'r', budgeted sale, X is assumed independent variable and actual sale, Y is assumed dependent variable. By calculating r we can examine where there is positive correlation between budgeted and actual production or not. There should be positive correlation between budgeted production and actual production to be a plan more realistic. To know the significances of the calculated value of 'r' Probable Error, PE is calculated. For the probable error, the calculated value of 'r' is regarded as significance.

The calculated value of 'r' is – 0.22. The value 'r' shows that there is negative correlation between actual and budgeted production. Increase in budgeted sale will decrease actual sale or vice versa. As correlation is – 0.22 the relation between

budgeted and actual sale is assumed more unreliable and assumed to be perfectly negative. For best performance, correlation must lie between '0.7 to 1'.

The calculated value of probable error is 0.287. considering probable error, it is found that the value of P.E. is more than Correlation coefficient (i.e.  $0.287 > -0.22$ ). So it can be concluded that calculated value of  $r$  is not significant and actual sale will not go in the same direction that of budgeted sale.

Regression analysis is the most favorable method of forecasting technique and too shows the relation figuratively between the variables. The regression allows finding the relationship that best fits the data. The general regression line is given by the following formula:

$$Y = a + bX$$

Where 'a' is the intercept at which the regression line meets Y axis and the 'b' is the slope of the line.

The regression line of the budgeted sale (X) and the actual sale (Y) can be calculated as:

$$(X - \bar{X}) = r * \frac{u_x}{u_y} (Y - \bar{Y})$$

Here from the table,

$$\bar{Y} = 470, \bar{X} = 619, x = 59.48, y = 52 \text{ and } 'r' = -0.22$$

Submitting the values in the above equation, we have,

$$X - 619 = -0.22 * \frac{59.48}{52} (Y - 470)$$

$$X-619 = -0.2516(Y-470)$$

$$X = -0.2516Y + 737.252$$

Here the regression equation of budgeted sales on actual sales is:

$$X = -0.2516Y + 737.252$$

The equation shows that the decrease of Rs.0.2516 will be in budgeted sales for Rs one increase in the actual sales.

Similarly, regression equation of the actual sales on budgeted sales can also be determined, but the above formula is to be used in both the ways.

The budgeted and actual sales can be predicted by using the above formula.

#### **4.2.2 Production Budget, Planning and Control**

After the completion of sales plan, the next step of comprehensive profit planning process in the manufacturing concern is to formulate a production plan. The production plan involves determining the number of units of each product that must be manufactured to meet planned sales and maintain the planned inventory levels of finished goods. The production plan depends upon the capacity of plant and requirement of sales plan. The general concept of production plan has been discussed in Chapter II.

HPPCL has been producing several types of products. These products have been using different types of aromatic and medicinal plants in processed and raw form. Thus the production plan of HPPCL is highly dependent on the availability of crude herbs that are based upon various controllable factors like appropriate weather or season, policy about forest resources. As HPPCL cultivates, collects and processes the medicinal and aromatic plants within the company and outside the company involving private sector and produces essential oils as industrial raw materials and herbal care products as consumer products. Therefore, the products of company are highly heterogeneous in nature. Because of heterogeneous nature of products, it is difficult to predetermine the quantities to be produced in long-range periods of future that creates complication in production plan. The main objective of the production plan is to fulfill the sales plan requirement.

While developing the production plan, factors that affect in production planning have to be identified and appropriate production plan should be develop. To develop the production plan following formula can be used:

$$\text{Units to be produced} = \text{Total requirement for sales} + \text{ending inventory} - \text{Beginning inventory}$$

HPPCL has a practice of preparing the production budget only on a tentative basis and for short term. The company has no systematic policy and plan about production. From the past practice of the company, it is obvious that the company has a practice to measure various types of products in the same unit and sum together. However, the literature suggests that the units of different products cannot be combined together. Thus, the research study attempts to recommend the appropriate way to production plan also.

To analyze production budget, sales budget must be analyzed as is done in previous analyses. Sales budget is the foundation of production budget, which varies according to the sales budget. As it varies according to the sales budget, there must be consistency between budgeted and actual data of production budget. To identify the production trend of past and to forecast the targeted and actual achievement are considered. Following table (Table 4) shows the targeted production and actual production achievement from fiscal year 2063/64 to 2067/68 that represent long-term production plan.

**Table 3: Annual Total Budgeted and Actual Production for 2063/64-2067/68**

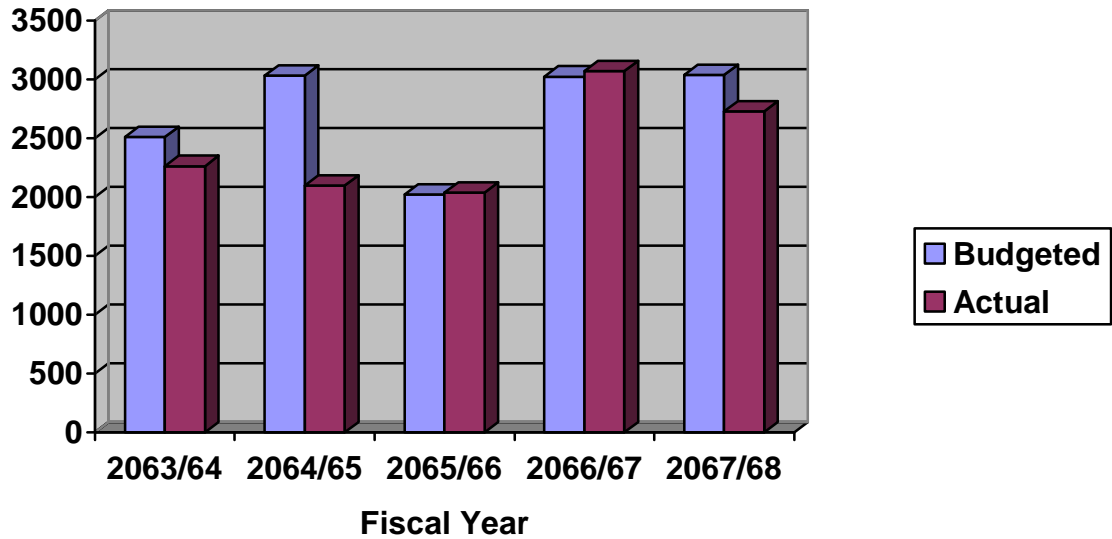
Rs. in '000'

<b>Fiscal year</b>	<b>Budgeted Production (Rs)</b>	<b>Actual Production (Rs)</b>	<b>Variance in amount (Rs)</b>	<b>Variance in %</b>
2063/64	2510	2263	(247)	9.840
2064/65	3030	2098	(932)	30.759
2065/66	2022	2037	15	0.742
2066/67	3023	3068.378	45.37	1.50
2067/68	3035	2727	(308)	10.14

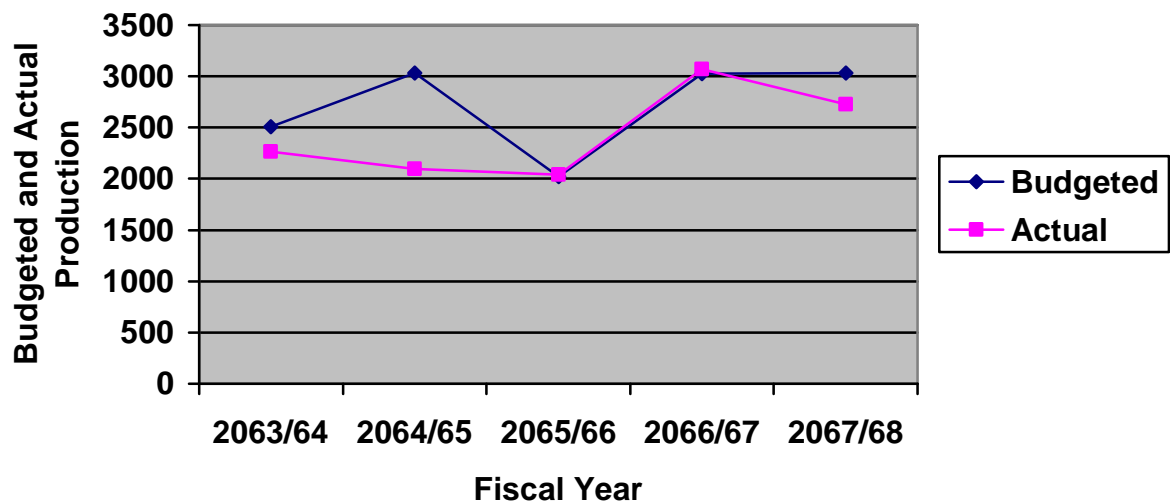
Source: Annual Reports of HPPCL

The above table shows that the relationship between target and actual production of each year is satisfactory except 2064/65.

HPPCL does not prepare the proper production budget. HPPCL does not produce all the products. Some of them are purchased as crude herbs and collection from different form. It creates complication in production plan. The above table shows that actual production is merely below than budgeted production in each year. Actual production is nearly satisfactory with respect to budgeted production. However, target and actual production are fluctuating from year to year. Thus, there is no systematic and scientific production plan. There are many factors that affect the production plan. In the case of production, company mainly depends upon the raw material. Due to the lack of appropriate time, climate, weather, season, geographical condition, sufficient finance, working environment, commitment to work HPPCL has been facing many problems in production situation activities.



**Figure 3: Annual Budgeted and Actual Production of HPPCL**



**Figure 4: Actual Achievement of Budgeted Production**

**Table 4: Arithmetic Mean, Standard Deviation, Coefficients of Variation and Correlation, and Probable Error of Budgeted X and Actual Production, Y**

Rs. in '000'

Year	X	$x = X - \bar{X}$	$x^2$	Y	$y = Y - \bar{Y}$	$y^2$	xy
2063/64	2510	-214	45796	2263	-175.67	30860	37593.38
2064/65	3030	306	93636	2098	-340.67	116056	-104245
2065/66	2022	-702	492804	2037	-401.67	161338.78	281972.34
2066/67	3023	299	89401	3068.37	629.7	396522	188280.3
2067/68	3035	311	96721	2727	288.33	83134.18	89670.63
	13620		818358	12193.37		787910.96	493271.65

**For Budgeted Production,**

**Calculation of Mean ( $\bar{X}$ ), Standard Deviation ( ) and Coefficient of Variation**

$$\begin{aligned} 1. \text{ Mean } (\bar{X}) &= \frac{\sum X}{N} \\ &= \frac{13620}{5} \\ &= 2724 \end{aligned}$$

$$\begin{aligned} 2. \text{ Standard Deviation ( )} &= \sqrt{\frac{\sum \phi x^2}{n}} \\ &= \sqrt{\frac{818358}{5}} \\ &= \sqrt{163671.6} \\ &= 404.563 \end{aligned}$$

$$\begin{aligned} 3. \text{ Coefficient of Variation (C.V.)} &= \frac{u}{\bar{X}} * 100 \\ &= \frac{404.563}{2724} * 100 \\ &= 14.851\% \end{aligned}$$

**For Actual Production,**

$$\begin{aligned} \text{sMean } (\bar{X}) &= \frac{Y}{n} \\ &= \frac{12193.37}{5} \\ &= 2438.67 \end{aligned}$$

$$2. \text{ Standard Deviation ( )} = \sqrt{\frac{\sum \phi y^2}{n}}$$

$$\begin{aligned}
&= \sqrt{\frac{787910.96}{5}} \\
&= \sqrt{157582.192} \\
&= 396.96
\end{aligned}$$

$$\begin{aligned}
3. \text{ Coefficient of Variation (C.V.)} &= \frac{U}{\bar{Y}} * 100 \\
&= \frac{396.96}{2438.67} * 100 \\
&= 16.27\%
\end{aligned}$$

### Calculation of Correlation coefficient and Probable error

$$\begin{aligned}
\text{Correlation Coefficient, 'r'} &= \frac{xy}{\sqrt{x^2 y^2}} \\
&= \frac{49327.65}{\sqrt{818358 * 787910.96}} \\
&= \frac{493271.61}{802990} \\
&= .614
\end{aligned}$$

$$\begin{aligned}
\text{P.E} &= .6745 * \frac{1 Z r^2}{\sqrt{n}} \\
&= .6745 * \frac{1 Z (.614)^2}{\sqrt{5}} \\
&= .18
\end{aligned}$$

According to the above analysis, actual production is mostly less than budgeted. Variation in budgeted and actual sales is wide, as standard deviation also varies in both. Thus, above analysis shows that actual production is more variable than budgeted production. The coefficient of variation of actual production is higher than budgeted production. A distribution with smaller C.V. is said to be more homogenous

or less variable. The series with greater C.V. is said to be heterogeneous or more variable. The above result shows that actual production fluctuates more than budgeted production. Budgeted production is less variable than the actual production as it has lower C.V. than the actual production.

To find the correlation between the budgeted production and actual production, Karl Pearson's coefficient of correlation, ' $r$ ' is determined. For the purpose of calculation  $r$ , budgeted production, X is assumed to be independent variable and actual production, Y is assumed to be dependent variable. By calculating ' $r$ ', it can be examined whether there is positive correlation between budgeted and actual production or not. In other words, the actual production achievement increases or decreases according to the budgeted production. There should be positive correlation between budgeted production and actual production to be a plan more realistic. To know the significance of the calculated value of ' $r$ ' Probable error, PE is calculated. For the probable error, the calculated value of ' $r$ ' is regarded as significance.

The calculated value of ' $r$ ' is .614. The value  $r$  shows that there is positive correlation between actual and budgeted production. Increase in budgeted production will also increase actual production or vice versa. As correlation is .614 the relation between budgeted and actual production is assumed to be more reliable and assumed to be perfectly positive. For best performance correlation coefficient, ' $r$ ' must lie between 0.7 to 1.

The calculated value of probable error is 0.18. Considering probable error, it is found that the value of ' $r$ ' is more than P.E.( $r$ )(i.e.  $0.614 > 0.18$ ).so it can be concluded that calculated value of ' $r$ ' is significant and actual production will go in the same direction that of budgeted production.

Regression analysis is the most favorable method of forecasting technique and too shows the relation figuratively between the variables. The regression allows finding

the relationship that best fits the data. The general regression line is given by the following formula.

$$Y = a + bX$$

Where 'a' is the intercept where the regression line meets 'Y' axis and the 'b' is the slope of the line.

The regression line of the budgeted production, X and the actual production, Y can be calculated as:

$$(X - \bar{X}) = r \cdot \frac{u_x}{u_y} (Y - \bar{Y})$$

Here from the table,

$$\bar{Y} = 2438.87, \bar{X} = 2724, \quad s_x = 396.96, \quad s_y = 404.563, \quad \text{and } 'r' = 0.614$$

Submitting the values in the above equation, we have,

$$X - 2724 = .614 \cdot \frac{404.563}{396.96} (Y - 2438.67)$$

$$X - 2724 = .6257(Y - 2438.67)$$

$$X = .6257Y + 1198.13$$

Here the regression equation of budgeted sales on actual sales is

$$X = .6257Y + 1198.13$$

The equation shows that the increase of Rs.0.6215 will be in budgeted sales for Rs one increase in the actual sales.

Similarly, regression equation of the actual sales on budgeted sales can also be determined but we have to use the above formula in both the ways.

We can predict the budgeted and actual sales by using the above formula.

#### **4.2.3 Raw Material Budget and Planning and Control**

Raw material is one of the most important elements of production. Sufficient raw material will have to be available to meet production needs and to provide for the desired ending raw materials inventory. However, some quantity of material requirement will already exist in the form of beginning raw materials inventory. The remainder will have to be purchased from a supplier. A comprehensive budgeting includes Raw Material purchase budget also. Although comprehensive budgeting is a wider topic and it is insufficient to try to cover it in small research, this study has been done including some important budgets. In general sales budget is prepared at first and other plans and budgets are prepared. But in general availability of raw material determines all other plans and budgets. Raw material to be purchased by calculated by using the following formula:

$$\text{Raw material to be purchased} = \text{Raw material requirement} + \text{Closing stock of raw material} - \text{opening stock of raw material.}$$

Raw material budget is prepared by the combination of raw material and interim periods. It should clearly show that when and how much raw material is needed for production process and when and how to be purchased.

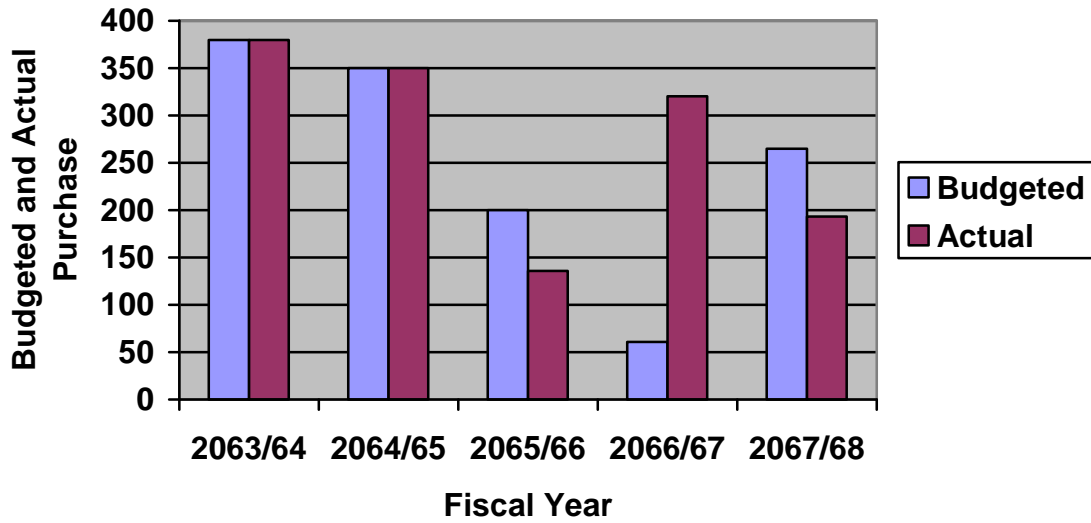
In case of HPPCL, it is seen that there is no practice of preparing 'Raw Material Budget' or 'Raw Material Purchase Budget'. They purchase or farm as much as they can as they are only one to purchase and process the herbal raw material.

Targeted and actual values of raw material are presented below and are analyzed presenting in graphs also.

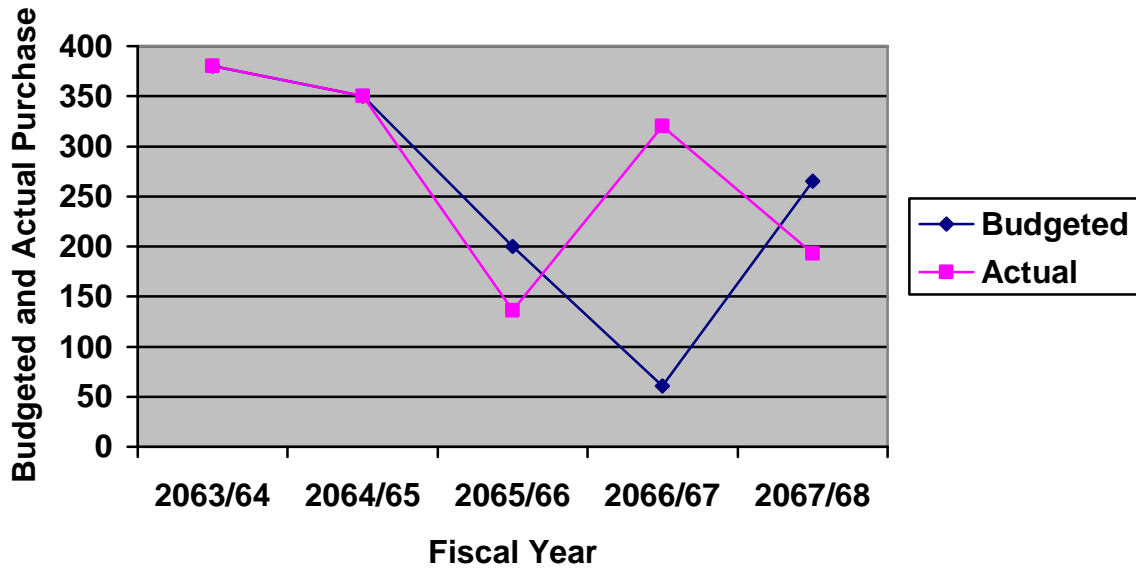
**Table 5: Annual Total Budgeted and Actual Purchases for 2063/64-2067/68**

In 'Metric Ton'

<b>Fiscal year</b>	<b>Budgeted Purchase (MT)</b>	<b>Actual Purchase (MT)</b>	<b>Variance in Quantity (MT)</b>	<b>Variance (in %)</b>
2063/64	380	380	0	0
2064/65	350	350	0	0
2065/66	200	135.8	(64.2)	(32.1)
2066/67	61	320	259	424.59
2067/68	265	193	(72)	27.16



**Figure 5: Annual Budgeted and Actual Purchases of HPPCL**



**Figure 6: Actual Achievement of Budgeted Purchases**

In the above table we found that there is a regular relation between the budgeted and actual but for the last two year it seems to be unrealistic and unbelievable.

#### **4.2.4 Inventory Consideration**

A better inventory policy makes the organization better because finished goods inventory plays a vital role in profit planning. The budgeted sales and the inventory affect the production volume. Inventory is not important part of production and sales. So that inventory is the cushion of sales and production. When production exceeds sales, then the excess production is kept into store and the inventory level will increase. The inventory level will decrease when sale exceeds production. A certain level of inventory is needed for smooth sales activities of the company. According to nature of companies, different companies may have different inventory policies. Generally, inventor level of finished goods is determined by nature of production, seasons and production processes, perish ability and other so many factors.

Finished goods represent final or complicated products that are available for sales. The inventory of such goods consists of items that have been produced but are yet to be sold.

HPPCL has followed a fluctuating inventory policy. It is a multi product company. It produces different kinds of products such as scented oils, crude herbs, other herbal products etc. so, HPPCL has not followed a strict and regulated inventory sufficiently kept to maintain some stock for primary sales, though the policy is not strictly followed.

#### **4.2.5 Cost Volume Profit Analysis**

Cost volume profit analysis is an analytical tool for studying the relationship between cost (i.e. fixed and variable), volume (i.e. quantity and Rs.) and profit (i.e. quantity and Rs).

Break even analysis is a logical extension of marginal costing. It is based on same principles of classifying the operation expenses into fixed and variable. Now a day it has become a powerful instrument in the hands of policy makers to maximize profit. There may be change in the level of production due to many reasons such as competition, introduction of a new product, trade depression or bloom, increased demand of product, scarce resources change in the selling process of products etc n such case management must study the effect on profit on account of the changing level of production. A number of techniques can be used as an aid to management in this respect, one such technique is beak-even analysis.

The term breakeven analysis is interpreted in the narrower as well as broader sense. Used in its narrower sense, it is concerned with finding out the break-even point i.e level of activities where the total cost equals total selling price. Used in its broader sense it means that system of analysis that determines the probable profit at any level of production. The break-even analysis established the relationship of cost, volume and profit. So, this analysis is also known as cost volume profit analysis.

The study of break-even analysis can be made by ☺ 1) Mathematical relationship between cost volume and profit. (2) By preparing break even charts. In order to understand mathematical relationship between cost, volume and profit it is desirable to understand the four concepts their calculation and application.

HPPCL has no any rule to analyze its financial performance by using this tool. It is very difficult to analyze using this technique because HPPCL has not adopting the systematic costing system and classification of cost behavior. Thus BEP analysis of HPPCL is based on the following assumption.

- ) It is based on profit and loss account of Fiscal Year 2067/68.
- ) Opening and closing stock does not change.
- ) Selling price is fixed and variable cast is assumed to be remaining constant.
- ) Calculations are based on total basis.
- ) Others types of income are not included in total revenues.
- ) Activity based is selected in terms of sales revenues.

$$\text{Total sales revenue} = 53672046.68 \mid 53672047$$

$$\begin{aligned} \text{Total fixed cost} &= \text{Administrative expenses} + \text{Depreciation} + \text{Interest} \\ &= 19475909.57 + 1532740.43 + 2960940 \\ &= 23969589 \end{aligned}$$

$$\begin{aligned} \text{Total variable cost} &= \text{Production} + \text{Collection} + \text{Processing} + \text{Selling expenses} \\ &= 32911764.22 + 159113.23 \\ &= 33070877 \end{aligned}$$

$$\text{Profit (Loss)} = (3368420)$$

Now, calculation of BEP,

$$\begin{aligned} \text{Contribution margin (C.M)} &= \text{Sales revenue} - \text{Variable cast} \\ &= 53672046 - 33070877 \\ &= 20601169 \end{aligned}$$

Now,

$$\begin{aligned}\text{Profit volume ratio (P/V ratio)} &= \frac{C.M}{Sales} \\ &= \frac{20601169}{53672046} \\ &= 0.3838\end{aligned}$$

$$\begin{aligned}\text{Variable cost ratio} &= 1 - \text{P/V ratio} \\ &= 1 - 0.3838 \\ &= 0.6162 \\ &= 61.62\%\end{aligned}$$

$$\begin{aligned}\text{B.E.P. of HPPCL (In Rs)} &= \frac{\text{Fixed Cost}}{P/V \text{ ratio}} \\ &= \frac{23969589}{.3838} \\ &= \text{Rs } 6245332.46\end{aligned}$$

$$\begin{aligned}\text{Margin of Safety} &= \frac{\text{Profit / Loss}}{P/V \text{ ratio}} \\ &= \frac{(3368420)}{0.3838} \\ &= (8776498.176)\end{aligned}$$

The calculated Break Even Point (BEP) presents that the cost and profitability is not good in HPPCL. On the other hand, HPPCL working with its full ability so, it is difficult to increase the production and sales to meet the break even point without increasing other fixed cost and in other hand it is in a competitive position so it is also difficult to meet the break even point easily.

The above calculated BEP shows either HPPCL is operating with high cost or the prices are kept low because a high cost or low price clearly reveals a high BEP. There is no clear record and cost classification system. top managers who were in the decision

making level are not in favor of cost control and scientific record of cost which shows that scientific finance sector of HPPCL is wrong. Without classification of cost there is no chance of cost control. The collection procedure is also not good. it has to buy all which are produced as per their rule.

Due to the above reasons there is a negative BEP and is seen uncontrollable for some coming years.

### **4.3 Major Findings**

The major findings of the study based on different analysis, observations and information are as follows:

1. HPPCL has practiced short-term planning rather than long-term planning.
2. Sales planning have not been practicing properly in HPPCL but only estimated annual targets ate prepared.
3. There is a remarkable difference between the budgeted and actual sales .Actual sales are always les than the budgeted sales.
4. Correlation coefficient of any factor is not satisfactory.
5. The top-level executive are only involved in planning and decision-making and lower level participation are not encouraged.
6. Inadequate planning due to lack of planning experts.
7. No any proper management to supply the herbs and herbs products in domestic and international market.
8. Inadequate forecasting system making HPPCL worse.
9. Actual sales have not met BEP level, which is not a running strategy.
10. HPPCL dos not prepare expenses budget separately.
11. There is low productivity of work force and plant.

## Chapter V

### Summary, Conclusions and Recommendations

#### 5.1 Summary

To analyze and examine the budgeting process as a tool of profit planning and control in one of the Nepalese public enterprises, *viz.* Herbs Production and Processing Company Limited HPPCL has been taken as a unit of study. The public sector enterprises can play an active and important role in augmenting internal resources for the socio-economic development of the country. In Nepal, public enterprises were established with the objectives for creating employment opportunities to the public at large. However, most of the Nepalese manufacturing PEs lack clear-cut specific goals and objectives and as such, there are no clear policies and procedures. In addition, due to inadequate knowledge about profit planning and lack of planning expert most of the manufacturing public enterprises are suffering from excess amount of production cost, high amount of fixed cost and the problem of too much staffing.

Profit planning is one of the most important management tools for planning and controlling business operations. The effective operation of a business can be determined by the excess of income over expenditure. Profit plan can be broadly divided into two groups as functional plan and financial plan. Functional plan includes: sales plan, production plan, raw material plan, direct labor plan and expenses plan, direct labor plan and expenses plan, financial plan includes cash flow plans, capital expenditure plan, projected balance sheet. Time dimension is another important consideration in profit planning.

HPPCL is selected as a unit of study. It was established on 12<sup>th</sup> Poush, 2038 B.S. in the public sector as an undertaking of erstwhile HMG/Nepal. The head office of HPPCL is located on its own land at Koteshwor, Kathmandu. It has been operating in loss since establishment until now. HPPCL deals with various types of medicinal and aromatic plants in both processed and unprocessed forms. Its main objective is to encourage the private sector in herbs farming and processing and promote exports of processed herbs.

Now a day, HPPCL has been able to export different kinds of products such as *Targets oil, Jatamasi oil, Calamus oil, Juniper oil, camumile oil* and *lemongrass oil* as well as exotic varieties like *Palmorasa oil, citronella oil, French Basil oil, Turpentine oil* and some crude drugs to neighboring and third countries.

The basic objective of the present study is to have an insight into the current practice and application of profit planning and control in HPPCL. To achieve the basic objective of the study five-year data, 2063/64 to 2067/68 have been gathered and analyzed. Both primary and secondary data are used in this study. Correlation, Regression, BEP are used as financial and statistical tools.

## **5.2 Conclusions**

The major conclusions of the study are as follows:

### **1. Traditional Method of Budget Preparation:**

HPPCL does not have separate budget section responsible for preparing and implementing budgets. As such, the accounting department initiates budgeting process by developing a form and administering it to different departments and sections. The people in different departments and sections fill it up taking reference of the last year budget. They do not have envisaged programmes based on which the form is filled. Finally, the budgets are approved by the Board of Directors and then sent to the concerned Ministry to allocate resources accordingly. However, the budgets are again subject to the Government scrutiny. Budgets in HPPCL thus are prepared on traditional basis because of lack of skilled planners and budgeting experts. HPPCL prepares budget just for the sake formalities and not for the profit planning purpose.

### **2. No Systematic Sales Planning**

Sales plan is perhaps the most important plan of all plans as all other plans are based on this plan. HPPCL does not practice systematic sales planning system. It has no proper system of forecasting sales. Forecasting of sales is based on whims

of the staff of the sales department. Preparation of sales plan is thus a sheer guesswork.

### **3. Lack of Appropriate Inventory Policy**

HPPCL has no appropriate inventory policy. Inventory is simply the result of unused portion of raw materials and unsold part of produced items of product, rather than the result of HPPCL's clear-cut inventory policy. HPPCL does not prepare any inventory plan either. Therefore, sometimes raw materials are not available in right quantity and at right time to supply for production and processing, and thus production is hampered. It mainly keeps the record of inventory items and their turnover. It does not use inventory techniques such as economic order quantity and different levels of inventory. It does not use ABC method of inventory either.

### **4. Labour Budget not Prepared**

HPPCL does not prepare any kind of labour budget, neither direct labour nor indirect labour. All workers and employees are paid their wages and salary on monthly basis. Therefore, it does not feel necessary to prepare such budgets.

### **5. Cash Budget not Prepared**

HPPCL has no practice of preparing cash budget that is necessary for the future cash planning and matching of cash flows to avoid cash shortages. Even the accounting staff is not conversant to the method of preparation of cash budget.

### **6. Overhead Budget not Prepared**

HPPCL is seriously suffering from excessive fixed costs and non-manufacturing expenses. This is the result of the lack of not preparing any overhead budget.

## **7. Gloomy Financial Picture**

The trend of profit and loss of HPPCL shows that there have been losses in all the years of study period. Due to heavy accumulated losses of HPPCL, the financial position of HPPCL is serious.

## **8. No Analysis of Annual Reports**

HPPCL does not have the practice of analyzing the various reports, including annual reports and the Report of the Office of the Auditor's General. Therefore, the management of HPPCL is not conscious to rating the causes of variance.

## **9. High Variance Between Budgeted and Actual Performance**

The analyses of the budgeted and actual sales, production and expenditures show that there is high variance between the budgeted and actual performance. This is perhaps the result of deficiencies in the preparation and implementation of different budgets.

## **10. Unfavourable Cost-Volume-Profit Analysis**

The analysis of the relationship between cost, volume of output and sales, and profit situation of HPPCL exhibits unfavorable situation of the company. This point has not been taken into account while preparing different kinds of budgets.

## **11. Lack of Well Communication System**

There is no well communication system. The communication is only limited to the top-level management. The objective goals and policies are not identified in participation with the employees. There is no coordination between top-level management and lower level management. There is no cooperation and coordination between planning people with the rest of the people in the accounting department.

### **5.3 Recommendations**

The following recommendations have been offered to improve the existing budgeting or profit planning control system in HPPCL.

#### **1. Define Clear-cut Objectives and Formulation of Strategies**

Objectives are the main bases for the preparation of different kinds of budgets in any organization; HPPCL cannot be an exception. Therefore, HPPCL's objectives should be clearly defined by highlighting its vision, mission, long-term and short-term goals.

For some years, HPPCL is facing competition from the private sector enterprises and from the imports of herbal medicines from China, India, Malaysia and Singapore. Therefore, it is high time for HPPCL to formulate competitive strategies for meeting the challenges posed by competing domestic as well as foreign products.

#### **2. Prepare, Communicate and Implement Budgeting Manuals**

HPPCL should prepare budgeting manuals for the preparation of budget. The profit planning manual is that which explains the broad objectives, company's goals, strategies and other executive management instruction, issued by top level of management in development of profit plans for the upcoming budget year. These manuals should be communicated from top level to lower levels by organizing seminars and workshops. If required, the accounting department should also provide assistance and support in effective preparation and implementation of the budgets.

#### **3. Prepare Realistic Budget**

Considering the deteriorating financial condition and its market share, and competition it is facing now, it should try hard to prepare budgets that are realistic in that they should not be based on whims of the employees who prepare them. Before the preparation of the budgets, market survey should be conducted to

obtain realistic data and information. Based on the survey data HPPCL should attempt to forecast its sales using reliable and dependable methods. HPPCL should prepare all type of budget components of the comprehensive profit planning and control.

#### **4. Raise Productivity, Profitability and Reduce Expenses**

HPPCL should raise its productivity, particularly the labour and employee productivity. In order to increase employee productivity, they should be provided adequate training to use their skills in raising productivity. They should be motivated to enhance productivity by relating their jobs with the survival of the company, such as, “if HPPCL survives, only then their jobs are safe”.

HPPCL is accumulating heavy losses every year during the period of study. As a result, its profitability is negative, which is particularly due to the excessive overheads, particularly administrative and office expenses. To have positive profitability of HPPCL, therefore, it is necessary to cut unproductive expenses, particularly overstaffing expenses. HPPCL should fire redundant employees with suitable package of compensation. The political and governmental intervention in its operation should be stopped at once, particularly the political appointment of employees. It should not be made political recruitment centre in any case, as public money is invested in it.

#### **5. Plan Cash and Inventory Well**

HPPCL is suffering heavy losses and therefore, shortage of cash time and again. Therefore, it should plan its cash flows well to avoid embarrassment of cash shortages. For this purpose, HPPCL should prepare the detailed cash budget by showing all receipts and payments of cash.

Similarly, it should sell out its over inventory to improve its financial position by launching aggressive advertisement campaign. Its advertisement campaign should contain materials like ‘*its state-owned company*’, and ‘*herbal medicines are pure and effective*’. HPPCL promote and sell its products in a manner Singh

*Durbar Vaidyakhana* and *Dairy Development Corporation* are selling their products.

#### **6. Take Reports Seriously**

Every year the Office of the Auditor's General (OAG) conducts annual audit of HPPCL and presents report to the Parliament. It should, therefore, seriously study the report of the OAG, take corrective measures to areas of weaknesses pointed out by the OAG, and try to regularize the financial discipline.

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## **Appendix 1**

### **Product line and products of HPPCL**

(A) Product line :Regular Herbal Care Product

1. Sancho

(B)Product line: Seasonal Herbal Care Product

1. Nepal Oil

2. Himalaya Massage Oil

3. Anti Leech Oil

(C)Product line: Essential Oils

1. Anthopogam Oil

2. Artemisia Oil

3. Calamus Oil

4. Camomil Oil

5. Citronella Oil

6. Curcuma Zedoria Oil

7. French Basil Oil

8. Jatamasi Oil

9. Juniper Berry Oil

10. Lemon Grass Oil

11. Mentha Arveness Oil

12. Palma Roja Oil

13. Sugandha Oil

14. Tagetes Oil

15. Turpentine Oil

16. Wintergreen Oil

17. Xanthoxylum Oil

18. Linchen Extract

19. Vasaka Liquid Extract

20. Eucalyptus Oil

## Appendix 2

### Research Questionnaire

**a) Name of respondent:**

**b) Position:**

**c) Department:**

**d) Tenure of service:**

Would you be so kind to answer the following questions properly and tick [ ] as one or more boxes, please?

1. Would you please mention the mission & purpose of the company?

a)-----

b)-----

2. Would you please mention the long range objective of the company?

a)-----

b)-----

3. What were the specific goals for the fiscal year 2067/68?

a)-----

b)-----

4. Was the achievement satisfactory?

a) Yes [ ] b) No [ ]

5. If no, please state the main causes of low achievement.

a)-----

b)-----

6. What were the achievements of specific goals during fiscal year 2067/68?

a) Return on capital employed in % [     ]

b) Net profit margin on sales in % [     ]

c) Capital utilization in % [     ]

d) Others [     ]

7. Would you please state the periods covered by profit planning in this company?

a) Is there a practice of preparing long-range plan? If yes what is the period covered by the plan? [     ]

b) What is the period covered by short –range plan? [     ]

8. What are the major external variables that present opportunities for & threats to the company?

Opportunities:

I)-----

II)-----

Threats:

I)-----

II)-----

9. What are the main internal variables that create significant strength & weakness of the company?

Strengths:

I)-----

II)-----

Weaknesses:

I)-----

II)-----

10. To what level planning premises are communicated?

- a) From top to lower level
- b) From top to middle
- c) From top level only

11. Who evaluates the relevant variables?

- a) Budget committee [     ]
- b) Planning department [     ]
- c) Top management [     ]
- d) Other [     ]

12. What are the bases for sales plan?

- a) Management guidelines [     ]
- b) Manufacturing capacity [     ]
- c) Sources of raw materials &supplies, goods for resale [     ]
- d) Availability of key people or a labor force [     ]
- e) Capital availability [     ]
- f) Availability of alternative distribution channels [     ]
- g) Forecasting tools [     ]
- h) All of above. [     ]

13. On what basis sales budget is prepared?

- a) Forecasted sales unit [       ]
- b) Estimated increase by promotional tools & media [       ]
- c) Estimated increase and decrease by SWOT analysis [       ]
- d) Unit selling price [       ]
- e) Total sales in amount [       ]

14. On what basis sales & production budgets are prepared?

- a) Territory wise [       ]
- b) Product wise [       ]
- c) Month wise [       ]
- d) Quarter wise [       ]
- e) All of above [       ]

15) Do you think that sales achievement is satisfactory? If not, why?

a)-----

b)-----

16. How many sales territories the company has segmented, would you please state the name?

a)-----

b)-----

17) What promotional tools & media are usually used?

a) Sales promotion

Consumer promotion	Trade promotion	Sales promotion
Free samples[ ]	Free goods[ ]	Sales contests[ ]
Coupons[ ]	Allowances[ ]	Trade shows[ ]
Price-off[ ]	Price off[ ]	Gift items[ ]
Premium/gifts[ ]	Sales contests[ ]	Promotional kits[ ]
Contest/prizes[ ]	Gift items[ ]	Bonus commission[ ]
rebates[ ]	Credit facilities[ ]	

b) Personal selling

Personal communication[ ]
Persuasion[ ]

c) Advertisement

Print media	Visualmedia/audiomedia	Audio visual media
Newspapers[ ]	Display songs[ ]	Television[ ]
Journals[ ]	Point of purchase display[ ]	Videotapes[ ]
Booklets[ ]	Skywriting[ ]	Cinema[ ]
Pamphlets[ ]	Exhibits[ ]	
	Radio[ ]	
	Tape[ ]	

18. What pricing method has been accepted?

Cost plus/markup[ ]	Going rate[ ]	Value pricing[ ]
Target return[ ]	Below competition[ ]	Perceived value[ ]
Break even[ ]	Above competition[ ]	
	Sealed-bid[ ]	

19. Sales are on

- a) Credit [ ]
- b) Cash [ ]
- c) Both [ ]

20. If credit sales exist, what is the collection period?

-----  
-----

21. What production policy has been adopted?

- a) Stable production policy [ ]
- b) Flexible production policy [ ]
- c) Both [ ]

22. What purchasing policy has been adopted?

- a)-----
- b)-----

23. What inventory policy has been adopted?

a) For finished good inventory

-----

b) For raw material inventory

-----

24. From which market raw material are purchased? If raw material is manufactured in the company, what are the pricing policies?

-----

-----

25. What is the activity measurement base?

a) Production units [ ]

b) Sales units [ ]

c) Sales Rs[ ]

d) Others [ ]

26. What is the wages payment system?

a) Daily wage payment system [ ]

b) Monthly wages payment system [ ]

c) Piecework wages payment system [ ]

d) Other

27. Are there clear duties and responsibilities provided to each employee?

-----

-----

28. What is the company's performance evaluation system?

a) Ratio analysis [ ]

- b) Standard costing [   ]
- c) Performance reports [   ]
- d) Flexible budget [   ]
- e) Cost volume profit analysis [   ]
- f) Others [   ]

29. What evaluation criteria are used to evaluate major capital expenditure?

- a) Pay back period method. [   ]
- b) Accounting rate of return method [   ]
- c) Net present value method [   ]
- d) Internal rate of return method [   ]
- e) Profitability index method [   ]

30. How are excess fund utilized?

- a) Bank deposit [   ]
- b) Purchasing security [   ]
- c) Purchasing government treasury [   ]
- d) Other [   ]

31. Which department has the overall responsibility of profit planning?

-----  
 -----

32. Would you please highlight in brief, the basic problems faced by this company in formulating & implementing profit plans?

- a)-----
- b)-----