3.9 - Budgeting

Outcomes

HL only	Depth of teaching
The importance of budgets for organizations	AO2
The difference between cost and profit centres	AO1
The roles of cost and profit centres	AO2
Variances	AO2, AO4
The role of budgets and variances in strategic planning	AO2

What is a budget

<u>A budget is a quantitative expression of a plan of action prepared in advance of the period to which it relates</u>**. It must be a plan and not a forecast – a forecast is a prediction of what might happen in the future, where as a budget is a planned outcome which the firm hopes to achieve. A budget will show the money needed for spending and how this might be financed.**

Budgets are based on the objectives of the business.

Why make a budget?

Essential Characteristics of Budgets

- They are prepared and agreed in advance.
- Cover a specific time period.
- They are expressed in either financial terms or in real terms (that is physical quantities).
- They relate either to the firm as a whole or to a part of it (such as the marketing department).

Functions of Budgets

- To assist the planning process
- To communicate plans.
- To coordinate activities and ensure harmony between different parts of an organisation.
- Clarification of authority and responsibility.
- To motivate staff.
- To control and evaluate performance.

Why make a budget?

Limitations of Budgets

- inflexible: once set and agreed, budgets are fixed for the year
- time consuming to produce and are therefore expensive
- focused on the short term
- everyone involved in budgeting has to be trained – slow and expensive
- budgets for one-off projects are very difficult to make accurate

What is in a budget?

Information contained in a budget may include any or a combination of the following:

- Revenue
- Sales
- Expenses
- Profit
- Personnel
- Cash
- Capital

These are referred to as Budget Factors. A budget can include any business variable which can be given a value

Cost and Profit Centres

Cost Centre – clearly identifiable parts of the business where **costs** can be attributed. Usually departmental, such as human resources, as these do not earn revenue, therefore do not make direct profits.

Profit Centre – clearly identifiable parts of the business (product, geography) where both **costs and revenues** can be attributed.

Cost and Profit Centres

Cost Centre – the business is able to better track where costs are being allocated, improve budgeting, make decisions about future resource allocation. These are often hit hardest when cost cuts are required, as they provide no direct revenue streams

Profit Centre – the business is able to better track the profitability of different sections of the business, improve budgeting, make decisions about future resource allocation. Not all parts of a business earn revenue, so cannot be considered profit centres.

How to budget.

Incremental Budgeting: This uses last year's budget as a basis and an adjustment is made for the coming year.

This means that each department does not have to justify its whole budget for the coming year – only the change or 'increment'.

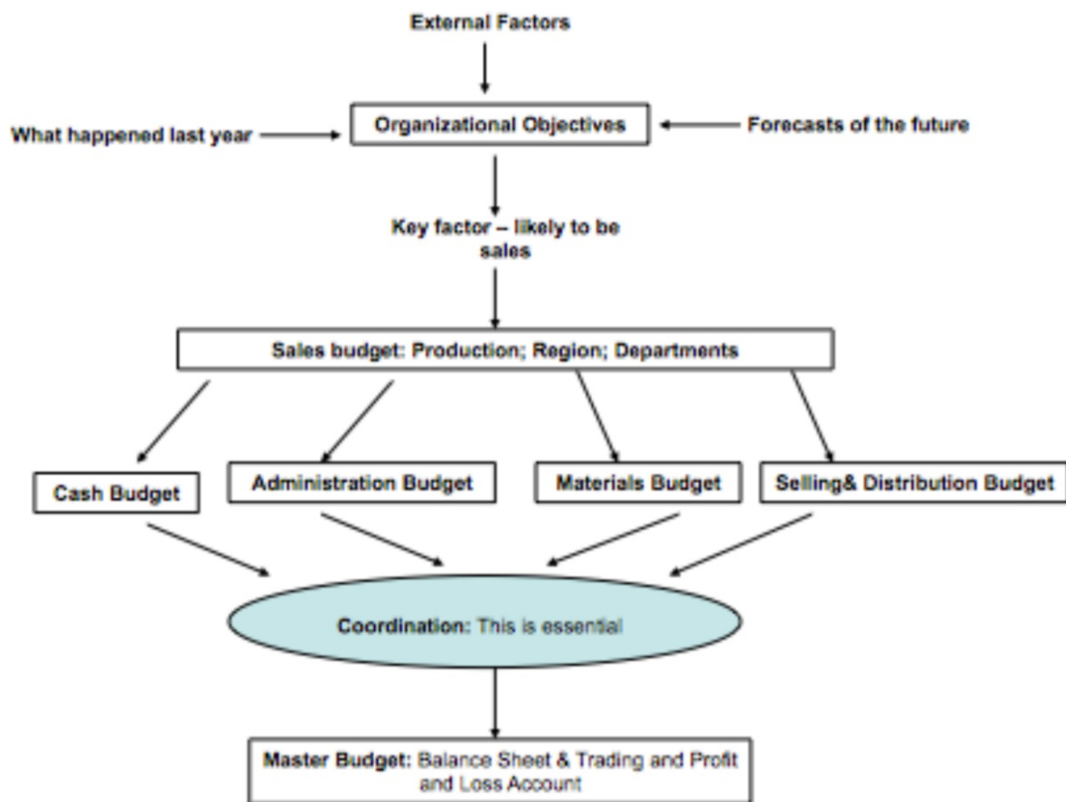
On the other hand, this type of budgeting does not allow for unforeseen events.

Zero Bases Budgeting: This requires all departments and budget holders to justify their whole budget each year.

This type of budgeting provides added incentives for managers to defend the work of their own section. Also changing situations can be reflected in very different budget levels each year.

On the other hand, this type of budgeting can be time consuming, as fundamental review of the work and importance of each budget-holding section is needed each year.

The budget process



What is a variance?

A variance is the difference between the actual outcomes and the budget outcomes.

Variance = Actual outcome - Budgeted outcome

A favourable variance exists when the difference is financially beneficial to the organization.

An unfavourable (or adverse) variance exists when the difference is financially detrimental to the organization.

Variances should never be explained as positive or negative as a positive 'difference' could actually be unfavourable to the business financially.

Furthermore, a business should consider a number of variances together rather than each individual variance.

What is a variance?

Table 3.4a *Variance analysis for Meigh Visual Arts Company, period ending 30th June*

	Actual value ($)	Budgeted value ($)	Variance ($)
Sales	55,000	50,000	
Raw materials	18,000	15,000	
Staffing	23,000	25,000	
Marketing	14,000	12,000	
Rent	20,000	20,000	

Variance can also be explained as a percentage or a quantity

Interpreting variances

Benefits of variance analysis

It allows senior managers to monitor the performance of the organisation as a whole, as well as different sections of the organisation.

Prompt variance analysis allows managers to assess whether variances re caused by internal or external factors.

By identifying variances and their causes managers may be able to produce more accurate budgets in the future. This will aid planning and perhaps improve the performance of the business.

Budgetary control in general helps improve accountability in the business

Budgeting and strategic planning

Budgeting is a financial process outlining 'what is expected' in the coming year. This will include the expected sales revenue, expected costs and other quantitative factors - all forming a master budget.

On the other hand, Strategic planning is the search for 'what is possible' and is formed by the long-range goals and ambitions of the organisation, such as vision, mission and other organizational aims.

These can be quantifiable meaning budgeting plays a role in strategic planning, however, it is only one aspect and cannot provide the qualitative information needed to plan adequately.