

Budgeting revision – A2

Budgets

The purposes of budgets

Budgets are future financial plans drawn up with the aim of giving some focus and parameters for business activity. They can encompass financial budgets and non-financial activities.

Performance

Budgets are frequently set for:

- cash
- sales
- marketing
- production
- administration

The use of budgets can improve the performance of a business because they can:

- help with overall business planning
- provide targets and/or limitations for the business and/or its departments
- aid the effective allocation of resources to the various business functions
- add an element of control as actual figures can be compared to the budgeted ones
- act as a motivational tool as departmental managers will aim to work within their budgets
- help departmental managers to understand their role in the achievement of overall business objectives

Benefits and drawbacks of the use of budgets

Benefits

- They introduce an element of financial control.
- They allow senior managers to identify parts of the business that are underperforming and to take corrective action.
- Targets can be motivating if they are realistic.
- They can allow managers to see the impact of their budget and those of other managers on the overall aims of the business.

Drawbacks

- Unrealistic budgets can be demotivating.
- Managers might argue a case for a higher budget than is necessary.
- A manager who has under-spent might buy unnecessary items to avoid having the budget reduced the following year.
- Inflexible budgets might prevent a business from reacting to a sudden change in the market.
- Lack of information can make it difficult to draw up a realistic budget for a new business or for a one-off project.

How budgets might be produced

- Budgets can take the overall business objective(s) as a starting point.
- They can break down the business objective(s) into departmental or divisional budgets.
- They are frequently based on what has happened in previous years together with what the business realistically expects to happen in the future.
- Discussion often takes place with the **budget holder(s)** to agree the budget based on the business objective(s) and other available relevant information, e.g. current material costs.
- Budgeted figures often use last year's figures as a starting point. This often results in the current year's budget being last year's figure plus a small increase.
- They are set perhaps monthly or quarterly.

Zero budgeting

Zero budgeting ignores any previous budgets and requires that each budget holder puts forward a case for the next period's budget. They need to produce a plan for what they expect to achieve and what they need to achieve it. They must be able to justify all of their figures.

This method prevents 'budget creep' when departmental budgets are increased slightly each year without any detailed analysis taking place into whether or not an increase is necessary. This can be wasteful and might not reflect the changing needs of the different departments in a business.

Purposes of budgets for allocating resources and controlling and monitoring a business

Resource allocation

The setting of budgets is likely to encourage a detailed plan of what resources will be needed and how resources are to be allocated in order to achieve the best outcome for the business.

For example, budgeting can cause a business to identify that if a market becomes more competitive, it might be sensible to allocate more resources to the marketing department. The marketing department might see its budget increased to allow it to react to the market situation.

Controlling and monitoring

- Inefficient use of resources can be identified and corrected.
- Progress towards achieving corporate or department objectives can be measured.
- Over-spending budget holders can be identified and the cause of any over-spend can be investigated (not all over-spending is unnecessary; circumstances might have changed since the budget was set).
- The performance and progress of a department or division can be measured against the budget.
- Departments requiring additional funding can be identified.

Role of budgets in appraising a business

The success of a business can be measured by how well it meets the targets contained in its budgets. These budgets may be closely related to business objectives. A business that exceeds the expectations in the budgets would be judged to be successful, while one that continually fails to meet the expectations outlined in its budgets would need to investigate the reasons for the underperformance. It might be that the budgets were set at an unrealistic level.

Variances: adverse, favourable

The meaning of variances

When an actual outcome is different from the budgeted outcome it is said to vary. The difference between the budgeted outcome and the actual outcome is known as the **variance**.

An actual figure achieved can be better or worse than the budgeted figure. When the actual figure is worse, the variance is said to be **'adverse'** and when the actual figure is better than the budgeted figure, the variance is said to be **'favourable'**.

Variance analysis is the when the causes of any differences are investigated.

Calculation and interpretation of variances

A restaurant has the following information regarding its budgeted figures and the actual figures for the month.

Table 1 Calculation and interpretation of variances

Item	Budget (\$)	Actual (\$)	Difference (\$)	Favourable (F) or Adverse (A)
Rent	1,850	1,850	0	Neutral
Ingredients	2,450	2,800	350	A
Heat and light	320	300	20	F
Wages	600	630	30	A

Often a higher actual figure indicates an adverse variance but not always. In the case of output, a higher actual figure than the budgeted one is a favourable variance because this indicates that the business achieved a higher than expected level of output.

In the case of the restaurant above, if the budgeted number of meals had been 1,000 but actually 1,150 meals were prepared and served, this would be a favourable variance on the budgeted meals. An increase in the number of meals served could also account for the higher cost of the ingredients and wages. Such variances in costs should also be assessed in terms of the output that they contributed towards.

Revision activity

Investigate and make a list of the various types of budgets that might be produced in a business. Using that list, write down as many reasons as you can for why the actual figures for each of the budgets might vary from the budgeted ones.

Variance: the difference between the budgeted figure and the actual figure achieved.

Variance analysis: the process of determining the cause of any difference between budgeted and actual figures and whether the variance is favourable or adverse.

Adverse variance: when the actual figure is a poorer outcome for the business than the budgeted figure.

Favourable variance: when the actual figure achieved is a better outcome for the business than the budgeted figure.