FACTFILE:
GCE PROFESSIONAL BUSINESS SERVICES

UNIT AS 3: FINANCIAL DECISION MAKING – BUDGETING

Learning Outcomes

Students should be able to:

- outline and explain the types of budget (including master, production, sales, labour and raw materials) a business might use;
- understand the reasons for setting a budget;
- calculate and interpret adverse and favourable variances;
- analyse the reasons for and implications of addvers and favourable variences.

Budgeting

Budget definition:

A budget is a plan expressed in financial terms, covering the activities of a business for a future specified time period.

Reasons for setting a budget:

- Facilitates decision making – allows managers to make decisions, e.g. resource allocation; spending decisions.
- Enables greater coordination – allows departmental managers to coordinate business activities to ensure achievement of business goals, e.g. enables production managers to plan production activities to ensure the sales targets are achieved in the next financial year.
- Improves communication – a budget enables managers to communicate with each other up/down a management hierarchy and/or across functional departments which enables greater awareness of organisational and departmental activities/goals, e.g. maintaining market share would suggest that the sales team must sell the same amount as last year, therefore the production department must produce similar quantities to enable the sales targets to be achieved, therefore the management team must be aware of such objectives to ensure success.
- Enables control – mangers can review actual business activities against the budget/plan. Differences between actual results and budgeted results can then be analysed and corrective action taken to ensure achievement of business goals.

Types of budget:

There are various types of budgets including:
- Fixed
- Flexible

In a business, budgets are often prepared in sequence, in order to facilitate decision making, planning and control. The following sequence is usually adopted:

- Sales budget: this budget is prepared to establish sales quantities, revenues and overall totals.
- Production budget: this budget is prepared to determine the costs and quantities of production required to meet the sales budget.
- Materials budget: this budget is prepared to determine the planned levels of materials/ components, specifications, quantities and related costs.
- Labour budget: this budget is prepared to determine the planned levels of staff, grades, working hours and related costs of staff resources.
- Overheads budget: this budget is prepared to determine the likely expenses which are incurred in support of business activities, e.g. light/heat and general expenses.
- Cash budget (cash flow forecast): this budget is prepared to determine the amount of cash in the business at any point in time, enabling managers to quantify the timing and amount of cash inflows and cash outflows.
- Master budget: this budget is prepared to determine the budgeted overall financial position of the business – typically summarised through a budgeted Income Statement and budgeted Statement of Financial Position.

Variances

Variances:

A variance simply represents the difference between the 'budget' and 'actual' amounts reported for any financial item.

A variance is calculated using the following formula:

Variance = Budget – Actual

Types of Variance:

Favourable Variance – this represents a 'positive' difference between the budget and actual amounts, e.g. if a business spent £100 on advertising in the last financial year, but had planned to spend £150, then this gives rise to a favourable variance of £50. Calculated as follows:

Variance:
Budget – Actual = Variance
£150 -£100 = £50F

Adverse Variance – this represents a 'negative' difference between the budget and actual amounts, e.g. if a business spent £166 on stationery in the last financial year, but had planned to spend £150, then this gives rise to an adverse variance of £16. Calculated as follows:

Variance:
Budget – Actual = Variance
£150 -£166 = £16A

**Note: A favourable variance is often denoted as 'F' after the number; An Adverse variance is often denoted as 'A' (or written as a minus figure).*

Sales Variance:

A sales variance arises due to a difference between budgeted sales and actual sales.

Case Studies:

1. Sales Variance:
Leafy Limited planned to produce and sell 100,000 lettuces resulting in £100,000 sales revenue in the last financial period. At the year end, the manager reported that the actual sales revenue amounted to £80,000.

Sales Variance = Budget – Actual
£20,000(A) = £100,000 - £80,000

This variance is adverse as fewer lettuces were sold than originally planned – this might have been due to bad weather conditions during the year, reducing the amount of crops grown.

2. Materials Variance:
Bear Limited planned to produce 10,000 teddy bears, using 1,000 kgs of materials (e.g. foam), costing a total of £10,000. During the trading period, the supplier announced that the price of materials supplied had to increase due to an unexpected increase in delivery costs. This meant that Bear Limited had to spend a total of £11,000 on materials.

Materials Variance = Budget – Actual
£1,000(A) = £10,000 - £11,000

This variance is adverse as the costs of materials supplied was greater than originally anticipated.

3. Labour Variance:
A labour variance arises due to a difference between planned and actual costs related to staff – this could include a range of issues such as wages, hours worked or number of staff employed.
Example:

Chattty Limited employs 100 factory operatives to produce 100,000 mobile phones. The staff work a total of 1,500 hours each per year and the total wages bill amounted to £1.5m in the last financial year, however the budgeted wages bill was originally calculated at £1.6m.

Labour Variance = Budget – Actual
£0.1m F = £1.6m - £1.5m

This variance is favourable since the actual amount spent on wages was £100,000 less than planned – this might be due to fewer hours or less overtime being worked than originally anticipated, therefore saving the business this money. This could be considered as more efficient.

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Summary

A budget is a plan of action expressed in financial terms, covering the activities of a business for a future specified time period.

A budget can used to ensure that a business is run in an efficient and effective manner.

A budget enables managers to make decisions, plan and control the activities of the business.

Budgets are usually prepared in sequence, resulting in the preparation of the master budget which summaries the overall planned financial position.

Variances enable managers to investigate differences between actual performance and planned performance. Such differences can be investigated and corrective action taken to improve fu-ture performance.

A variance is calculated as follows:
Variance = Budget – Actual.

Variances can be denoted as either Favourable (F) or Adverse (A).

Revision Questions

1. Define the term 'budget'.

2. Define the term 'variance'.

3. Green Limited planned to produce and sell 100,000 turnips resulting in £100,000 sales revenue in the last financial period. At the year end, the manager reported that the actual sales revenue amounted to £110,000. Calculate the sales revenue variance and explain one reason why it might have arisen.

4. Icy Limited planned to produce 20,000 1L-tubs of ice cream, using 2,000 litres of milk, costing a total of £200,000. During the trading period, the supplier announced that the price of milk supplied had fallen to due an unexpected decrease in feeding costs for the animals. This meant that Icy Limited had spent a total of £180,000 on milk. Calculate the materials variance and explain one reason why it might have arisen.

5. Mobile Limited employs 500 factory operatives to produce 500,000 mobile phones. The staff work a total of 1,500 hours each per year and the total wages bill amounted to £7.5m in the last financial year, however the budgeted wages bill was originally calculated at £7m. Calculate the labour variance and explain one reason why it might have arisen.

Sources for further study

www.bbc.co.uk/news/business

www.investni.com/news/index.html

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