3.9 Budgets: Activity A

1. Define the following terms: **[4 marks]**

i. Budgeted figures

A budget refers to a financial plan for expected revenue and expenditure for an organization (or a department within an organization), for a given period of time. Budgeted figures are the figures used in this financial plan and these are then compared with the actual figures to find out the variances for the variance analysis.

ii. Variance

Variance refers to any discrepancy between actual outcomes and budgeted outcomes. Favourable variances exist when the variance is beneficial for the business, such as sales being higher than budgeted or costs turning out to be lower than expected. The opposite is true for adverse (unfavourable) variances.

2. Explain how a manufacturing business sets budgets for sales and costs. **[4 marks]**

A budget refers to a financial plan for expected revenue and expenditure for an organization for a given period of time. There are actually several ways that an organization might set its budgets, and these are chosen bearing in mind the purpose of the budget and also the organisational objectives of the firm.

For a manufacturing business, there would be a few ways that a business could set up budgets for sales and costs. One way in which this can be done is through using historical data. Budgets are actually often based on what has happened in the past, and this helps to set trends for future budgets. For Oasis Cookers, this would not actually be the ideal method, as it can be seen that currently, the economy is experiencing a downturn, and so figures are bound to be very different from last year. Another method that could be used is through looking at the available finance. This would involve Oasis Cookers Ltd to look at the amount of funds available to the business so they would be able to see how where each lot can be placed in the budget. The greater the financial strength of the business, the greater the amount of funds that are available, and the opposite is also true. This is a good method as the current financial stability of the business can be taken into account. However, along with this, when setting a budget for sales and costs, the manufacturing business would also go through many process and would have to consider questions like how much the firm should spend in each department, how many workers are needed, and how much money should be set aside for a contingency fund. These answers to the questions would aid the manufacturing business in knowing the future sales and costs which would therefore help the business set up a budget for the sales and costs.

3. Calculate the variances to complete table 1; indicate whether the variances are favourable or unfavourable. **[6 marks]**

Budgeted and actual figures for the year ending 31 December 2015				
$000	**Budgeted figures**	**Actual figures**	**Variance**	
Sales revenue	165	150	15	Adverse
Cost of materials	80	70	10	Favourable
Labour costs	22	23	1	Adverse
Gross profit	63	57	6	Adverse
Overheads	40	43	3	Adverse
Net profit	23	14	9	Adverse

4. Using the variance results, comment on the performance of Oasis Cookers during the year. [4 marks]

Variance refers to any discrepancy between actual outcomes and budgeted outcomes. Favourable variances exist when the variance is beneficial for the business, such as sales being higher than budgeted or costs turning out to be lower than expected. The opposite is true for adverse (unfavourable) variances.

From the variance analysis above, it can be seen that the overall performance of Oasis Cookers has actually not been that great during the year. Firstly, it can be seen the budgeted figure for the sales revenue turned out to be $15 000 less in the actual value. This was an adverse variable that would have affected the profit of the business greatly. And then, among the costs, apart from the costs of material, all other costs were adverse. Adding this together, it was shown that the business had actually spent $4 000 more on costs than budgeted for. Also, the net profit of the business, which was budgeted to be $23 000, but turned out to be only $14 000, meant that this variable was also adverse. Through this, it can be seen that, with many of the factors turning out to be adverse and this could be due to the limitations of the budget. Two main limitations are prominent here, unforeseen changes and being over-generous with the budget. Through the figures in the variance analysis though, it can also be seen that the overall performance of Oasis Cookers was not great.

5. Evaluate the usefulness of budgets to a business such as Oasis Cookers. [7 marks]

A budget refers to a financial plan for expected revenue and expenditure for an organisation for a given period of time. Budgets are a very useful tool for businesses and this is because for the business there are many advantages to budgeting, however there are disadvantages as well.

Budgeting is important because it allows business managers to plan ahead and anticipate financial problems. It acts as a measure of the progress businesses have made to achieve their organisational objectives, which is important for Oasis Cookers to ensure that they are achieving what they have been set to do, even in times where the economy is taking a downturn. Effective budget control is needed to ensure that the business continues and survives through the condition of the economy at the moment.

For Oasis Cookers, budgeting would help control the firm's money and would help the entire workforce to focus on common goals. Budgeting acts as a motivational factor, and again this is important considering the current situation. It also helps the business keep a tighter control of their finances, which would help Oasis Cookers in avoiding inefficient expenditure. This is because it would allow them to anticipate costs and revenues of different business activities, and hence allow them to agree on competing priorities and targets. Also, budgetary control can act as a method of allocating and clarifying responsibilities and this can act as a further source of motivation. However, despite these advantages, there are limitations to budgeting as well that need to be taken into consideration when a budget is being made, or else it would not prove to be too useful for the business. Firstly, a limitation is that there are likely to be unforeseen changes that can cause a large difference between the budgeted figures and the actual figures.

For example, for Oasis Cookers last year's budget, the change in the economy might have affected the budget too much, making it invalid. Unforeseen changes would include things like the downturn the economy is facing currently, and the unexpected high interest rates, and this would affect the cost of supplies for Oasis Cookers. Another limitation could include the mangers being overly generous for the budget, and this, could mean that the budget ends up being completely unreliable, and could lead the business into a false sense of security for the year. Budgets can also be rigid and poorly allocated and these types of budgets can result in lower quality of the final products of Oasis Cookers as well. Through this, it can be seen that the limitations of budgeting could have quite adverse effects, however, there are many advantages as well. Therefore, as a tool, budgeting is very useful for Oasis Cookers as it can help the business in anticipating future financial problems.

3.9 Budgets: Exam practice question

1. **Calculate the budgeted and actual profit figures.** **[2 marks]**

Budgeted net profit = $66 000 – ($15 000 + $12 000 + $6 000)
= $33 000

Actual net profit = $70 000 – ($18 000 + $17 000 + $5 000)
= $30 000

2. **Using variance analysis, discuss whether the management of Burton Inc.® should be satisfied with the performance of the business over the last 12 months.** **[10 marks]**

Budgeted and actual figures for the year ending 31 December 2012				
$000	**Budgeted figures**	**Actual figures**	**Variance**	
Sales revenue	66	70	4	Favourable
Direct labour	15	18	3	Adverse
Direct materials	12	17	5	Adverse
Fixed costs	6	5	1	Favourable
Profit	33	30	3	Adverse

Variance refers to any discrepancy between actual outcomes and budgeted outcomes. Favourable variances exist when the variance is beneficial for the business, such as sales being higher than budgeted or costs turning out to be lower than expected. The opposite is true for adverse (unfavourable) variances. A variance analysis shows the discrepancies for each certain cash inflows or outflows.

From the variance analysis shown above, it can be seen that for sales revenue and fixed costs, the outcomes were favourable variances, with $4 000 and $1 000 respectively being a benefit to the financial position of Burton Inc. However, all other variables did not show the same promise, and it can be seen that they were adverse variances totalling $11 000. Although, from this alone it could be quite hard to see whether Burton Inc. should be satisfied with the performance of the business over the last 12 months overall. Other information would also be needed, but just from the variance analysis, the answer would be no.

It can be seen that there are more adverse variance than favourable ones, and this could hint for the business that the costs have been higher, and so Burton Inc. could have been overspending. Underselling can be seen to not be a problem, as sales revenue was higher than budgeted and this could mean that the business has been working satisfactorily, however, the causes of this variance should be investigated nevertheless. It can be seen however that the performance could have been better. With so many adverse variables, this should be a clue for the business that their performance has not been as high as expected, and so something must be wrong, whether it is due to the limitations of budgeting or the faults of the business, and even this should be investigated. Overall though, just from the variable analysis, it should be said that Burton Inc. may not be as satisfied with its performance as it could have been better, according to budgeted figures.

3. Explain two other pieces of information that would have helped you in your answer to Question 2. [6 marks]

There are actually many other pieces of information that would have helped in seeing how Burton Inc. performed over the last 12 months, as it can be seen that the variable analysis alone is not enough to give all the information needed to determine the performance of the business.

One thing that could have also helped analyse how Burton Inc.'s performance was over the last 12 months is a cash flow statement of the year. A cash flow statement refers to the financial document that records the actual cash flows for a business over a specific time period. This would help because a breakdown of the net monthly cash flows could be seen over the year, and so information could be gained on where exactly extra costs had gone, and what months had better performance than others and why. Another piece of information that could have helped in determining how the performance of Burton Inc. was over the past year could have been through getting records of how each department within the business worked. Knowing things like the productivity of each department and what happened over the year, not only in terms of financial management, but also in terms of the other departments, such as marketing activities would help. Another piece of information that could help is a PESTLE analysis. Knowing the external environment of the business in terms of political, environmental, social, technological, legal and economic factors would help the business in being able to see what affected business performance throughout the year; for example: how was the general economy performing? This would be beneficial as through this information, qualitative data could be gathered to help rate the performance of Burton Inc. Therefore, it can be seen that other information is also required to make an accurate decision on whether or not Burton Inc. should be satisfied with its performance over the last year.

4. Evaluate the role of budgets and variances in strategic planning at Burton Inc®. [10 marks]

A budget is a systematic method of allocating financial, physical, and human resources to achieve strategic goals. Burton Inc. develops budgets in order to monitor progress toward their goals, help control spending, and predict cash flow and profit.

The central challenge that budget developers face is mapping out the future, something that can never be done with perfect precision. The fast pace of technological change and the complexities of global competition make developing effective budgets both more difficult and more important for Burton Inc.

Best practices linking budgets with planning

Important benefits of improving the budgeting process include better companywide understanding of strategic goals, more coordinated support for those goals, and an improved ability to respond quickly to competition. A discussion of best practices used by leading companies to develop budgets follows.

- **Link budget development to corporate strategy.**

Because the budget expresses how resources will be allocated and what measures will be used to evaluate progress, budget development is more effective when linked to overall corporate strategy. Linking the two gives all managers and employees a clearer understanding of strategic goals. This understanding, in turn, leads to greater support for goals, better coordination of tactics, and, ultimately, to stronger companywide performance at Burton Inc.

But how is such a link created? Companies that apply best practices find that communication plays an important role. Top management must take the lead in developing and communicating strategic goals. But to develop those goals, top management needs information about customers, competitors, economic and technological change - information that must come from customer-contact and support units. Companies that establish effective channels for communication find it easier to set challenging yet achievable strategic goals.

Setting goals before budgeting begins makes it easier for budget developers at all levels. When this happens, budget developers at Burton Inc. create from the start budgets that support strategic goals and that, therefore, need fewer revisions. Budget development then becomes not only faster and less costly but also far less frustrating.

- **Design procedures that allocate resources strategically.**

Within Burton Inc., competition for resources is inevitable. Every function and business unit needs funding for both capital and operating expenses - usually in excess of the actual resources available. This makes it critically important for Burton Inc. to design procedures so that resources are allocated to support key strategies.

Best practice companies find that resource allocation is part science, part art. Fortunately, following certain best practices leads to better results. One such practice is coordinating the review of operating and capital budgets. Doing this gives managers insight into the ways in which changes in one budget affect the other. Another practice is to develop sophisticated measures for evaluating proposed budgets. The measures used tend to vary by industry, but most take into account the company's weighted average cost of capital. Many measures also assess the degree of risk involved in competing plans of action, the costs or advantages associated with deferring action, as well as factors such as expected developments in interest rates. By using such measures, and by using cross-functional teams to examine action plans, companies can better select plans whose benefits will produce desired results. Finally, by monitoring the results of allocation efforts, companies can refine and improve their procedures.

- **Tie incentives to performance measures other than meeting budget targets.**

Many companies still evaluate managers primarily on how closely they hit budget targets. While this may seem logical, in reality this type of one-dimensional evaluation tempts managers to "win" by playing games with budget targets. Such game playing isn't always in the company's best interest.

At best practice companies, meeting budget targets is secondary to other performance measures. Such companies use a balanced set of performance measures to chart progress toward strategic goals, and use the same measures in their incentive programs. This reinforces the importance of key strategies and communicates what results will be rewarded.

At many companies, business unit managers are involved in identifying the measures that are most relevant for their operations. Typically, some measures are financial, while others track progress in other efforts. For example, an appropriate nonfinancial measure for one business unit may be product defect rate; for another, speed to market for new products. Once the measures are identified, higher-level management clarifies what targets each manager is expected to meet. Managers and employees receive training on the company's incentive program so that they understand the reason behind the rewards.

- **Link cost management efforts to budgeting.**

By linking cost management efforts to budgeting, companies improve the quality of information available for managers to use in developing their budgets. Accurate cost information is fundamental to budgeting. Companies that use accurate cost management techniques and provide budget developers with ready access to cost information improve both the accuracy and the speed of their budget process.

Standardizing the cost management system companywide is an important step in improving the link between cost management and budgeting. Many companies also have found activity-based costing (ABC) helpful in identifying the real cost of producing, selling, and delivering products and services. Even small- to medium-size companies are exploring the potential of ABC, as packaged software becomes more widely available and brings down the cost of engaging in this type of analysis.

Another best practice in linking cost management to budgeting is the strategic use of variance analysis. Variance analysis is the study of differences between budgeted and actual costs, or the study of costs at one company compared with industry averages. By using variance analysis to identify weaknesses, managers can identify areas where their organization needs to improve its performance. But managers must focus on those variances that have a significant impact. Otherwise, decision making and budgeting can become bogged down in trivial detail.

- **Reduce budget complexity and cycle time.**

Best practice companies strive to reduce budget complexity and streamline budgeting procedures. Such streamlining allows management to collect budget information, make allocation decisions, and communicate final targets in less time, at lower cost, and with less disruption to the company's core activities.

By controlling the number of budgets that are needed and by standardising budgeting methods, companies take important steps toward streamlining budgeting. Another key step is to minimize the amount of detail included

in the reports used to develop budgets. Also, in their effort to streamline budgeting, leading companies use information technology to automate budgeting and facilitate workflow. These companies make sure that budget developers are thoroughly trained in new technologies. This training, together with ongoing monitoring of information needs companywide, helps best practice companies deliver the right information to managers, on time and at the right cost.

- **Develop budgets that accommodate change.**

By developing budgets that accommodate change, companies can respond to competitive threats or opportunities more quickly and with greater precision. They can use resources efficiently to take advantage of the most promising opportunities. Furthermore, knowing that budgets have some flexibility frees budget developers from the need to "pad" budgets to cover a wide variety of possible developments. This leads to leaner, more realistic budgets.

Companies typically review budgets quarterly, monthly, or even weekly. By including in these reviews reports on changes in business conditions, companies alert managers that new tactics may be called for, if they are to meet their targets for the year. While it is important that budgets not be revised to cover up for poor performance or poor planning, best practice companies choose to revise budgets rather than adhere to budgets that do not reflect current conditions. Some companies rely on "rolling" or "continuous" forecasts rather than on traditional annual budgets. The chief difference between such forecasts and traditional budgets is that the forecast is updated with actual results as the company moves through the year. Figures for three or more subsequent quarters are projected in decreasing degree of detail.

One way in which Burton Inc. can build flexibility into budgets is to prioritise according to strategic importance action plans that were rejected due to resource limitations. By doing this, the firm can act swiftly and decisively if additional resources become available.

Another way in which best practice companies develop budgets that accommodate change is to require managers to create scenarios based on a variety of assumptions about business conditions. The affordability of powerful information technology allows for the creation of many "what if" scenarios. This practice makes it possible for companies to respond more quickly and effectively if actual conditions follow the pattern of a particular scenario. Burton Inc. can also build flexibility into budgets by setting aside funds at the business-unit level to take advantage of competitive opportunities. Some companies even establish separate subsidiaries to look into promising products or technologies.