3.9 Budgets (HL)

The importance of budgets and variance analysis in decision - making

Budgets are important for business decision-making for several reasons, as shown in **Figure 1**.

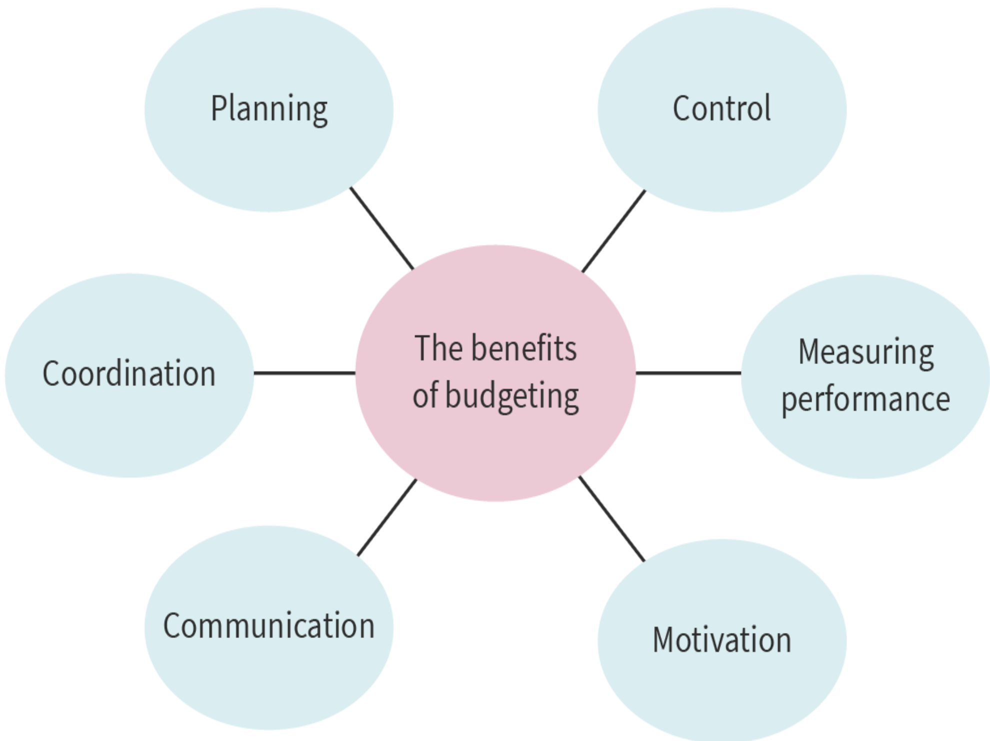

Figure 1. The importance of budgets and variance analysis for a business.

Planning

Budgets can help refine long-term plans. They assist management in planning for the future by estimating the financial resources that are needed to complete a particular objective. For example, if a business plans to bring out a series of new product lines, it can use budgeted data from previous product lines to help it set realistic targets and timescales. This means that decisions will be based on data rather than guesswork. Variances calculated on previous budgets are important because they will be used to adjust future budget plans.

Control

Budgets help control a business's activities and allow for better decision-making. Managers need to consider the impact on the budget before deciding on a particular course of action, which is important when making decisions. Quite often, a decision depends entirely on the impact it will have on the business's budget. In addition, large investments often have their own budgets to ensure they are as cost efficient as possible.

Figure 2. The budgeting process supports responsible spending and accounting of costs throughout the business.

Credit: Rob Daly, Getty Images

Measuring performance

The performance of a department or a manager can be evaluated by measuring their ability to stay within the budget. This is particularly important when cost control is a key target of the business. Variances are an important way of measuring budget management.

Motivation

A well-constructed budget can help motivate department managers to perform in line with the overall business objective and stay within budget. For example, departments that meet their objective but are under budget could receive additional bonuses for their staff. In contrast, a poorly constructed budget can be demotivating if managers feel they have not been allocated sufficient funds or that the organisation has prioritised different departments.

Communication

The management of a business can use the budget to communicate to the different departments how much they are expected to spend in order to achieve their objectives. This helps departments to structure their expenditure when implementing strategies to achieve their objectives.

Coordination

Budgets enable management to consider the relationship between different departments and to make sure that departmental plans are integrated. For example, a business with the objective to increase sales may have to allocate more funds to the marketing department in order to achieve this objective. It may also have to allocate more funds to human resources in order to recruit or train staff so that the increase in sales can be achieved.

Theory of Knowledge

Budgets are planned by looking at available financial data. Budgets help managers to plan business costs and revenues of different business departments. Managers agree on targets based on available finances and future trends. Budgets are planned in a way that reduces variances between the actual and the budgeted figures.

- Does the existence of a budget limit imagination and the pursuit of knowledge?
- Do budgets foster or limit creativity in business planning?

Activity

Learner profile: Inquirers
Approaches to learning: Research skills (information literacy)

Invite the Group 3 Individuals and Societies department head to your class to show and discuss the budget for the department. You could ask your teacher to help with this.

Ask them how the budgeting process works in your school and the role of the budget in school operations.

You may also want to ask them the Theory of Knowledge questions in the box above. For example, does having a budget make the department members more or less creative in their planning?