3.9 Budgets (HL)

Constructing a budget

A budget is a financial plan for a defined period of time. It includes a plan for future revenues and future costs. Budgets aid the planning, control, coordination and monitoring of a business's expenditure.

Budgets can be set for almost any part of a business. Departments, product lines, a factory or even a single salesperson can all be set budgets. The purpose of a budget is to outline the financial resources available for achieving the objectives of that part of the business.

Budgets are characterised by the fact that they are short term and coordinated.

- **Short-term budgets**. Budgets are usually set over a period of a year or for the duration of a project. However, some businesses may set monthly budgets, for example if it is necessary to monitor cost control on a monthly basis.
- **Coordinated budgets**. Departmental budgets are typically set after the business's corporate objectives have been agreed. Departmental budgets typically feed into a centralised budget for the whole business.

Factors to consider when constructing a budget

There is no set method of deciding the size of a budget. Some businesses choose to base their budgets on previous years. They look at how much money was allocated last year, then allocate a figure similar to that.

Other businesses may choose to use a method called 'zero-based' budgeting. This is where departments bid for how much money they need for the year, explaining what they believe they will need the money for. If they can justify their spending, they will be awarded the budget they asked for.

When drafting a budget that includes both revenue and cost predictions, managers will have to consider many different internal and external factors. Internally, they need to be aware of:

- changes to marketing decisions on product, price, promotion and other marketing factors (Subtopic 4.5 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/the-big-picture-id-39004)) that may affect the revenues and costs
- labour turnover issues that may affect recruitment and training costs, as well as salaries (Subtopic 2.4 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/the-big-picture-id-39054))
- operations changes that affect efficiency and waste (Subtopic 5.3 HL (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/the-big-picture-id-39339))

External factors (STEEPLE, Section 1.1.5 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/tool-swotsteeple-analysis-id-36504)) can also have an impact on budgets, for example:

- sociocultural changes that might require the business to change a product or target market, incurring costs
- technological changes that might require new capital investments
- economic changes, such as increases in inflation, that can increase costs or reduce revenues
- environmental changes that damage business infrastructure, or make resources harder and more expensive to acquire
- political changes that disrupt supply chains, making transport more expensive
- legal changes, for example new environmental protection laws, that can make operations more expensive
- ethical changes that may require changes to the product portfolio, or operations

So managers need to be forward-looking, flexible and not too optimistic!

Theory of Knowledge

Psychologists have outlined a number of ways that people make systematic errors in thinking about the world around them. These are called cognitive biases.

One cognitive bias that is relevant to budgets is what is called the **planning fallacy**. Human beings generally underestimate the amount of time a task will take. They plan less time than needed. This is a problem for budgets because when projects take longer than expected, they generally cost more to carry out.

Another cognitive bias that affects budgeting is **optimism bias**. Human beings tend to assume that they will experience positive events and underestimate the chance that negative events will happen. This bias affects cost estimates. Businesses are generally over optimistic when it comes to predicting both revenues and costs, with the result that budgets are often exceeded.

If you want to learn more about cognitive biases, The Decision Lab (https://thedecisionlab.com/) **is a good source to start from**.

- How can human beings adopt strategies to avoid cognitive biases when constructing budgets?

Making connections

The IB Psychology course has a section on the reliability of cognitive processes. That section of the course refers to a number of cognitive biases that may be relevant to the budgeting process.

Format of a budget

A budget for a profit centre will include sections for both revenues and costs. A budget for a cost centre will only have a listing of costs. The format of a budget for individual businesses may differ, but for the IB exam you are expected to use the format shown in **Table 1**.

Table 1. Budget for ABC Ltd for the period ending 2022 . *[F] indicates a favourable budget variance; [A] indicates an adverse budget variance.

All figures in millions of $	Budgeted figures	Actual figures	Variance

All figures in millions of $	Budgeted figures	Actual figures	Variance
Income			
Sales revenue	500	520	20 [F]*
Interest earned	40	35	5 [A]*
Total income	**540**	**555**	**15 [F]**
Costs			
Salaries and wages	150	180	30 [A]
Materials	80	75	5 [F]
Rent	15	15	0
Advertising	8	10	2 [A]
Electricity	12	9	3 [F]
Total costs	**265**	**289**	**24 [A]**
Net income	**275**	**266**	**9 [A]**

When formatting a budget as shown in **Table 1**:

- The budget should have a title (as with the final accounts and cash flow forecast).

- Multiple income (revenue) streams should be grouped together and summed.
- Multiple costs should be grouped together and summed.
- The net income will be the total income minus the total costs.

The final column includes information on the variance. A variance is the difference between the actual amount of income earned, or actual costs, and the budgeted figures and can be favourable [F] or adverse [A]. Variances are explored in greater detail in Section 3.9.3 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/variance-analysis-id-39334).

As you can see, a budget can look very similar to the statement of profit or loss that was introduced in Subtopic 3.4 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/the-big-picture-id-39045). However, there are some key differences:

- A budget is a forecast, whereas a profit and loss account is a summary of the previous 12 months.
- Publicly listed companies must publish statements of profit or loss, whereas budgets are internal documents used for planning.
- Budgets can be for any section of the business, whereas profit and loss accounts record all revenues and costs from the entire business.
- A budget can run over a month, a week or even a single day, whereas profit and loss accounts record all transactions for an entire year.

Activity

Learner profile: Knowledgeable
Approaches to learning: Thinking skills (transfer)

Pedro's Fix-It, a repair shop in Brazil, is creating a budget for 2023.

The business expects to have income of 950 000 BRL, all from sales revenue. Expected costs include salaries of 385 000 BRL, electricity of 50 000 BRL, rent of 300 000 BRL, advertising of 40 000 BRL and other overheads of 60 000 BRL.

- Construct a budget for Pedro's Fix-It based on these projected figures.