BUDGETS (5.6)

(Chapter 33 - A level 5.6)

A **budget** is a plan for the future, which an organisation aims to achieve. It is different from a forecast as a forecast is prepared based on assumptions.

A **budget holder** is an individual who is responsible for the initial setting and achievement of a budget.

<u>Budgets are used to :</u>

- ★ **Plan and improve upon plans**, having a budget helps managers set realistic plans
- ★ **Allocate and organise resources**, budgets help make sure the business does not spend more resources than it has access to
- ★ **Set realistic targets**
- ★ **Coordinate departments** in a business
- ★ **Monitor** and **control progress**
- ★ **Measures and assess performance**, once the budgeted period has ended, *variance analysis* will be used to compare actual performance with the original budgets

<u>Potential limitations of budgets :</u>

✔ **May lack flexibility** - so unexpected changes in the external environment will make them unrealistic
✔ **Focused on the short term -** managers may make a short-term decision to stay within a budget that won't be helpful longterm
✔ **May lead to unnecessary spending** - if there is extra money leftover, managers may choose to spend it so that the budget won't be decreased next time
✔ **May require training** - to learn how to set and keep to budgets

Types of budget

There are several ways in which the budget level can be set. The most widely used are **:**

- **Incremental budgeting -** the traditional way of budgeting that uses last year's budget as a basis for the next year, where adjustments (raising or lowering depending on how well they performed with the previous budget) can be made for the new year

- **Zero budgeting** - all budgets are set to zero initially then budget holders will have to argue their case as to how much finance they should receive and why. This can be time consuming and money may not end up going in the right places

- **Flexible budgeting** - once the budget is set, it is allowed to be changed if the estimated sales and production varies. This is helpful as business environment is dynamic

Variance analysis

The word **variance** means the difference between a planned value and the actual outcome.

Variance analysis refers to calculating the differences between budgets and actual performance, and analysing reasons for such differences.

Variance analysis :

- ➔ Compares the business's actual performance with the original budgets, this is a helpful way of also assessing a managers performance
- ➔ Helps explain why the outcome is different from what was planned
- ➔ Helps in setting future budgets by identifying past mistakes

(✖) **Adverse variance** means when the difference between the budgeted and actual figure leads to a lower-than-expected profit. This could be due to low sales, poor budgeting etc.

(✔) **Favourable variance** means when the difference between the budgeted and actual figure leads to a higher than-expected profit. This is usually due to high sales, lowered costs etc.