Budgets

A budget is a forecast of revenue and expenses over a specified future period. Budgets are utilized by corporations, governments, and households. Budgets are an integral part of running a business efficiently. Budgeting for companies serves as a plan of action for managers as well as a point of comparison at a period's end.

The budgeting process for companies can be challenging, particularly if customers don't pay on time or revenue and sales are intermittent. There are several types of budgets that companies use, including operating budgets and master budgets as well as static and flexible budgets. In this article, we explore how companies approach budgeting as well as how companies deal with missing their budgets.

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- A static budget is a budget with numbers based on planned outputs and inputs for each of the firm's divisions.
- A cash-flow budget helps managers determine the amount of cash being generated by a company during a period.

Flexible budgets contain the actual results and are compared to the company's static budget to identify any variances.

How Budgets Work

When most people think of budgets, the household budget comes to mind. Although the budgeting process for companies can become complex, a budget usually compares a company's revenue or profit versus its costs or expenses in a given period.

Of course, determining and forecasting how much to spend on various expenses and projecting sales is only part of the process. Company executives also have to contend with a myriad of other factors, including projecting capital expenditures, which are large purchases of fixed assets such as machinery or a new factory.

Companies must also plan for their ongoing cash needs, revenue shortfalls, and the economic backdrop. Regardless of the type of business, the ability to gauge performance using budgets is critical to a company's overall financial health.

Types of Budgets

Below are a few of the most common types of budgets that corporations use in forecasting their numbers.

Master Budget

Most companies will start with a master budget, which is a projection for the overall company. Master budgets typically forecast the entire fiscal year. The master budget will include projections for items on the income statement, the balance sheet, and the cash flow statement. These projections can include revenue, expenses, operating costs, sales, and capital expenditures.

Static Budget

A static budget is a budget with numbers based on planned outputs and inputs for each of the firm's divisions. A static budget is usually the first step of budgeting, which determines how much a company has and how much it will spend. The static budget looks at fixed expenses, which are not variable or dependent on production volumes and sales. For example, rent would be a fixed cost regardless of the sales volume for a company.

Some industries such as non-profits receive donations and grants resulting in a static budget from which they can't exceed. Other industries use static budgets as a starting point or a baseline number, similar to the master budget, and make adjustments at the end of the fiscal year if more or less is needed in the budget. When creating a static budget, managers use economic forecasting methods to determine realistic numbers.

Operating Budget
The operating budget includes the expenses and revenue generated from the day-to-day business operations of the company. The operating budget focuses on the operating expenses, including cost of goods sold (COGS) and the revenue or income. COGS is the cost of direct labor and direct materials that are tied to production.

The operating budget also represents the overhead and administrative costs directly tied to producing the goods and services. However, the operating budget wouldn't include items such as capital expenditures and long-term debt.

Cash-Flow Budget
A cash-flow budget helps managers determine the amount of cash being generated by a company during a period. The inflows and outflows of cash for a company are important because expenses need to be paid from the cash generated. For example, monitoring the collection of accounts receivables, which is money owed by customers, can help companies forecast the cash due in a particular period. Forecasting cash can be challenging if customers are given terms of 30 days to pay an invoice, but instead, pay in 90 days.

Cash flow budgets help to examine past practices to examine what's working and what's not and make adjustments. For example, a company could apply for a short-term working capital line of credit from a bank to ensure they cash in the event a client pays late. Also, companies can ask for more flexible options for their accounts payables, which is money owed to suppliers, to help with any short-term cash-flow needs.

Using a Budget to Evaluate Performance
Once a period has ended, management must compare the forecasts from the static or master budget to the company's performance. It's at this stage that companies calculate whether the budget came in line with planned expenditures and income.

Flexible Budget
A flexible budget is a budget containing figures based on actual output. The flexible budget is compared to the company's static budget to identify any variances (or differences) between the forecasted spending and the actual spending.

With a flexible budget, budgeted dollar values (i.e., costs or selling prices) are multiplied by actual units to determine what particular number will be given to a level of output or sales. The calculation yields the total variable costs involved in production. The second component of the flexible budget is the fixed costs. Typically, the fixed costs do not differ between static and flexible budgets.

Since flexible budgets use the current period's numbers—sales, revenue, and expenses—they can help create forecasts based on multiple scenarios. Companies can calculate various outcomes based on different outputs, such as sales or units produced. Flexible or variable budgets help managers plan for both low output and high output to help ready themselves regardless of the outcome.

Budget Variances
As stated earlier, variances can arise between the static budget and the actual results. The two common variances are called the flexible budget variance and sales-volume variance.
The flexible budget variance compares the flexible budget to actual results to determine the effects that prices or costs have had on operations.
The sales-volume variance compares the flexible budget to the static budget to determine the effect that a company's level of sales activity had on its operations.

From these two budgets, a company can develop individual flexible and static budgets for any element of its operations. The variances are classified as either favorable or unfavorable.
If the sales-volume variance is unfavorable (flexible budget is less than static budget), the company's sales (or production with a production volume variance) will turn out to be less than anticipated.

If, however, the flexible budget variance was unfavorable, it would be the result of prices or costs. By knowing where the company is falling short or exceeding the mark, managers can evaluate the company's performance more efficiently and use the findings to make the necessary changes.