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The big picture

Cost management is one of the most important aspects of the construction industry. However, the real costs of a project are often very different from the costs that were planned at the start of the project. Every year, large construction projects around the world end up costing more than expected. From the Gulf Railway line connecting Qatar to Saudi Arabia, to the Navi Mumbai International Airport in India, many major construction projects have proved to be notoriously difficult to execute according to budget.

Germany's Stuttgart 21 railway construction project is another recent example. When the project was announced in 1994, it was projected to cost $2 to 3 billion. With a projected minimum four-year end-date delay, the projected costs as of March 2022 are more than three times the original estimate. The video below explains how the construction costs exploded.

Video 1. The Stuttgart 21 mega-project.

A budget outlines planned spending and revenues for a period of time. Budgets help to give businesses financial discipline. They can set spending limits for managers who might otherwise be less cautious with the business's funds.

However, budgets are only an estimate. Budgets are only as reliable as the information on which they are based. In the real world, the external environment changes: resource costs may increase, equipment may break and revenue may be less than expected. When these things happen, it is important to be flexible. Budgets are only a guide; they are not set in stone.

But when a project goes over budget, both internal and external stakeholders will feel the impact. Profit margins may decline, resources may be wasted, and the business may even experience cash flow problems and face insolvency. So, good budgeting is essential to business sustainability.

In this subtopic, you will learn how to construct a budget and calculate variances. You will also learn the difference between cost centres and profit centres in a business.

Learning objectives from the IBDP Business Management guide with assessment objective level:

- **Distinguish** between cost and profit centres (AO2)

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- **Explain** the roles of cost and profit centres (AO2)
- **Explain** and **construct** a budget (AO2, AO4)
- **Explain** and **calculate** variances (AO2, AO4)
- **Explain** the importance of budgets and variances in decision-making (AO2)

3. Finance and accounts / 3.9 Budgets (HL)

Profit centres and cost centres

Cost and profit centres (HL) Roles of cost and profit centres (HL)

The difference between profit centres and cost centres

A company can prepare two types of budget. The first is for areas of the business that generate both revenue and costs, which are called profit centres. The second is for areas of the business that generate costs but no revenue, which are referred to as cost centres.

A single business may have many profit centres or cost centres depending on how it is organised. For example, a typical school will be split into academic departments. None of these departments generates revenue. But each department will have costs such as purchasing equipment and paying staff. Therefore, these departments will be classified as cost centres. The school shop or the school canteen, however, have both revenues and costs. These are classified as profit centres.

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Figure 1. A school canteen is considered a profit centre.

Credit: SDI Productions, Getty Images

Profit centres are any part of the business that contributes to the business's overall revenue. Areas of a business that have both costs and revenues are referred to as profit centres. The name makes sense as it would be hoped that costs would be less than revenues, so that a profit can be made. Profit centres are mostly used by large businesses that have a broad product portfolio. Each centre has a manager responsible for its operations who may produce an independent statement of profit or loss. Each profit centre contributes profit to the overall profits of the business.

Carrefour, for example, is a French multinational company; the eighth largest supermarket and hypermarket retailer globally by revenue. Each branch, however, is accountable for its own profit and loss account. Profit centres are common in businesses that are decentralised.

Figure 2. A school science department is considered a cost centre.

Credit: Hill Street Studios, Getty Images

A cost centre is responsible for predicting and managing its own operational costs. For example, school departments will each have a budget where costs are outlined for the coming school year. These will need approval from the school administration to ensure that revenues from other areas of the business can cover the costs. Non-profit social enterprises also tend to use cost centres.

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Exam tip

When analysing questions in the exam, it is important to remember that businesses can have both profit and cost centres. Large retailers such as JD.com, Walmart, Inditex and others operate profit centres for each of their branches. They also operate cost centres in their head office, market research teams and advertising departments.

How cost and profit centres are organised depends on how the business as a whole is organised. You learned about organisational structure in Subtopic 2.2 (/study/app/business-hl/sid-351-cid-762729/book/the-big-picture-id-39353/). Both profit centres and cost centres can be organised in a business by:

- **Function**. Each department in the business (such as marketing, finance, HR, IT or legal) is a specific cost centre.
- **Product**. Businesses that produce a variety of goods and services are mostly organised by products. For example, Adidas produces a range of sportswear and a range of sports equipment. Each product category is responsible for its own costs.
- **Geography**. Multinational businesses can be organised by their branches in different countries. For example, Samsung and Apple can organise their profit and cost centres by their geographical location.

The role of profit and cost centres

Profit and cost centres have a number of roles in the business.

Financial role

It is important for a business to have a clear view of how different departments are performing with regard to their revenues and costs. Separating out the profit centres by department, and the cost centres from the rest of the business, gives a clearer picture of the relative performance of different parts of the business. Managers can use this information to make budgets for the business as a whole with greater accuracy.

Motivational role

Separating profit and cost centres, and providing local discretion over financial managements, can provide teams of employees with a greater sense of autonomy over budgets. As you learned in Subtopic 2.4 (/study/app/business-hl/sid-351-cid-762729/book/the-big-picture-id-39054/), autonomy can improve motivation. Those employees on the ground in the different profit

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centres probably have a better sense of how to allocate funds than managers in an office far away. This can lead to greater efficiency and problem-solving on the ground. Departments that are successful at staying within their budgets can be rewarded.

Organisational role

With separate information on the relative importance of different profit and cost centres, managers can make better decisions about future strategy and where to invest. The business may choose to devote more time, money and energy to build on the profit successes of certain departments or units. Or it may decide to direct its attention and funds to those departments or units that are struggling. In any case, knowing the relative performance of the different parts of the business informs decision-making.

Activity

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

GEMS Education is a major private school provider operating in a number of countries. Founded in 1959 in the UAE, the network of schools has grown to 44 schools in the UAE and Qatar alone, with other educational institutions in south-east Asia, Europe, India, Africa and North America. GEMS schools use a number of curricula to provide their education, including many schools with the International Baccalaureate.

- Given the number and diversity of schools in the GEMS Education group, discuss with a partner or as a class why it would be beneficial for the company to treat each school as a profit centre.

2 section questions

Question 1

A 1 Profit centre ✓ is a department or unit of a company that generates revenue and has costs; therefore, its profit contribution to the company can be determined.

Accepted answers and explanation

#1 Profit centre

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Profit center

Question 2

What is the term used to describe a department or unit of a company that has costs but does not contribute to the profits of the business because it does not generate revenue?

Cost centre ✓

Accepted answers

Cost centre, Cost center

Explanation

A cost centre has costs but does not generate revenue. Examples might be the finance, IT, legal, human resources or other sections of a business that provide administration, but do not earn revenues for the business.

3. Finance and accounts / 3.9 Budgets (HL)

Constructing a budget

Constructing a budget (HL)

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.

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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/business-hl/sid-351-cid-762729/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/business-hl/sid-351-cid-762729/book/the-big-picture-id-39054/))
- operations changes that affect efficiency and waste (Subtopic 5.3 HL (/study/app/business-hl/sid-351-cid-762729/book/the-big-picture-id-39339/))

External factors (STEEPLE, Section 1.1.5 (/study/app/business-hl/sid-351-cid-762729/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!

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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
Income			

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All figures in millions of $	Budgeted figures	Actual figures	Variance
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/business-hl/sid-351-cid-762729/book/variance-analysis-id-39334/).

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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/business-hl/sid-351-cid-762729/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.

Budget for Pedro's Fix-It for year ending 2023 (in thousands of BRL

Income	
Sales revenue	
Total income	
Costs	
Salaries	
Electricity	
Rent	
Advertising	

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Income	
Other overheads	
Total costs	
Net income	

2 section questions

Question 1

A 1 budget ✓ is a financial tool that is used to aid the planning, control, coordination and monitoring of a business's expenditure over a period of time.

Accepted answers and explanation

#1 budget
Budget

Question 2

The following are all differences between a budget and a statement of profit or loss, **except**:

1. A statement of profit or loss is a projection of future revenues and costs, while a budget is a backward-looking document that accounts for what actually happened in the business. ✓
2. Publicly listed companies must publish a statement of profit or loss to the public, whereas a budget is an internal document used for planning.
3. A statement of profit or loss is an account of revenues and costs over an entire year, while a budget can be made for a shorter period of time.
4. A statement of profit or loss records revenues and costs from the entire business, while a budget can be created for any section of the business.

Student view

Explanation

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A budget is generally a forward-looking document that outlines expectations of income and costs for a future period of time. On the other hand, a statement of profit or loss is a backward-looking document that outlines what actually happened in the business.

All the other responses correctly outline differences between a budget and a statement of profit or loss.

Variance analysis

Variances (HL)

Variance analysis compares the budgeted (planned) income and expenditure of a business with the actual income and expenditure over a period of time. Budgets outline what a manager thinks will happen. Variance analysis compares the forecast with reality. When this comparison is made, there are three possible outcomes:

- **A favourable variance**. This occurs when the actual budget situation is better than the forecast and can happen when:
  - the actual costs are lower than the budgeted costs
  - the actual income is higher than the budgeted income
- **An adverse variance**. This occurs when the actual budget situation is worse than the forecast and can happen when:
  - the actual costs are higher than the budgeted costs
  - the actual income is lower than the budgeted income
- **No variance**. This means that the actual budget situation was the same as the forecasted budget.

Concept

Change

Change is a way of improving future planning for businesses. Business budgets need to be adjusted according to strategic and tactical factors, and in response to changes in the external environment. If budgets are not adjusted by businesses, the planning process and business objectives/targets become unrealistic or irrelevant.

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Table 1 shows the budget for 2021 for the Cosy Guest House in Hong Kong, which offers one room for guests. The room costs 2000 HKD per night, regardless of the time of year. The owner pays herself a salary. The information includes the budgeted figures, the actual figures and the variance. The variance is calculated by subtracting the budgeted figure from the actual figure.

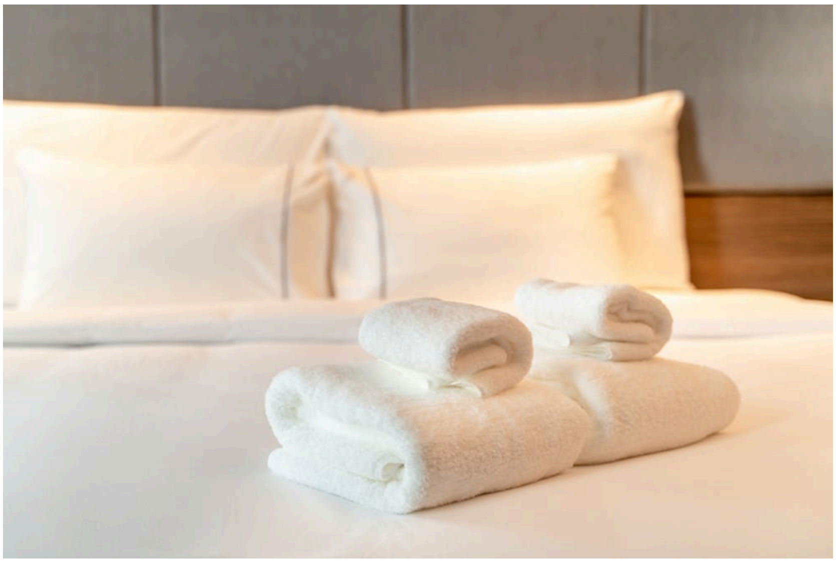

Figure 1. The Cosy Guest House offers just one room.

Credit: Kiyoshi Hijiki, Getty Images

Table 1. Budget for the Cosy Guest House for the period ending 2021. *[F] indicates a favourable budget variance; [A] indicates an adverse budget variance.

All figures in thousands of HKD	Budgeted figures	Actual figures	Variance
Income			
Sales revenue	400	550	150 [F]*
Total income	**400**	**550**	**150 [F]**
Costs			
Salary	300	300	0
Mortgage payment	50	50	0
Advertising	5	10	5 [A]*

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All figures in thousands of HKD	Budgeted figures	Actual figures	Variance
Electricity	10	15	5 [A]
Other overheads	5	20	15 [A]
Total costs	**370**	**395**	**25 [A]**
Net income	**30**	**155**	**125 [F]**

Exam tip

If the budget is for a cost centre, there will be no variance calculated for income.

Look carefully at **Table 1** to see what happened with the Cosy Guest House in 2021. Start by looking at the income. The Cosy Guest House had a projected income of 400 000 HKD. However the actual income was much higher, at 550 000 HKD. This resulted in a favourable budget variance of 150 000 HKD. This favourable variance is marked in the table with the letter [F].

Now look at the costs. Some of the actual costs, such as the salary of the owner and the mortgage payment, were in line with projected costs; the variance in these items was 0. However, the actual costs for advertising, electricity and other overheads was higher than the budgeted figures, resulting in adverse budget variances. These are marked in the table with the letter [A].

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The actual net income of 155 000 HKD was higher than the budgeted net income of 30 000 HKD. This resulted in a favourable budget variance of 125 000 HKD.

It is important to realise that the adverse budget variances shown in the costs for **Table 1** are not actually negative for the business. On the contrary, it seems that the increased advertising expenditure may have had a positive effect on sales revenue. In addition, the increase in electricity and other overheads was likely due to the higher-than-expected room sales. So, while a variance may be labelled as ‘adverse’, the information needs to be considered in the context of the entire budget situation to understand whether the adverse variance was truly negative for the business or not.

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Exam tip

An adverse cost variance is not always a bad thing. If variable costs have increased as a result of increased sales, this is a cost that most managers will be happy to pay, as long as enough working capital is available.

Activity

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

Taking the example from Pedro's Fix-It in Section 3.9.2 (/study/app/business-hl/sid-351-cid-762729/book/constructing-a-budget-id-39333/), use the information in the budget below to:

- Calculate the variances.
- Indicate whether each variance is favourable [F] or adverse [A].

Budget for Pedro's Fix-It for year ending 2023 (in thousands of BRL).

	Budgeted figures	**Actual figures**	**Varianc**
Income			
Sales revenue	950	925	
Total income	**950**	**925**	
Costs			
Salaries	385	385	
Electricity	50	60	
Rent	300	300	
Advertising	40	30	
Other overheads	60	55	
Total costs	**835**	**830**	
Net income	**115**	**95**	

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Budget for Pedro's Fix-It for year ending 2023 (in thousands of BRL

	Budgeted figures	Actual figures	
Income			
Sales revenue	950	925	
Total income	**950**	**925**	
Costs			
Salaries	385	385	
Electricity	50	60	
Rent	300	300	
Advertising	40	30	
Other overheads	60	55	
Total costs	**835**	**830**	
Net income	**115**	**95**	

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Case study

Figure 2. Inflation causes business costs to rise, often unexpectedly.
Credit: Jonathan Kitchen, Getty Images

The term inflation refers to an increase in the general price level in an economy. Inflation affects both businesses and consumers negatively. Consumers pay higher prices for products. But businesses also pay higher prices for their inputs; both physical inputs and labour. This can create a positive feedback loop where prices for a key resource increase, causing business costs to rise. Businesses raise prices to cover those costs and consumers, who are also workers, ask for higher salaries and wages. This increases business costs again and can cause further increases in prices.

In early 2022, countries around the world experienced higher than expected inflation. Inflation rates in many countries where prices had been quite stable for decades, neared double digits. They were even higher in countries with histories of less stable prices.

There were many reasons for this increase in inflation. Supply chains had been disrupted by the COVID-19 pandemic. Businesses found it difficult to obtain the resources they needed and had higher costs. Many workers in high income countries, unhappy with their working conditions, quit their jobs in what was called ‘The Great Resignation’, so many businesses found it difficult to recruit workers. Salaries and wages rose. In addition, geopolitical conflict disrupted global oil, gas and food markets, sending resource prices higher.

As a result, many businesses faced significantly higher costs of production than they had planned. Other businesses saw decreases in revenues as consumers had to direct more of their spending on necessity goods. Their budget variances for both the income and costs were adverse.

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Questions

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1. Define adverse variance. [2 marks]
2. Explain why inflation is likely to cause adverse variances for businesses for both costs and income. [4 marks]

Question 1

An adverse variance occurs when the actual budget situation is worse than the forecast. This could be because costs are higher than expected, incomes are lower than expected or profits are lower than expected.

Define is an AO1 level command term, requiring a precise meaning of a word.

- One mark is given for a vague definition.
- Two marks are given for a complete definition.
- Definitions do not require application to the stimulus material.

Question 2

Inflation is an increase in the general price level in an economy.

Inflation may cause adverse expense variances for a business. This is because inflation affects both final prices for consumers and the business costs to provide goods and services. The text explains that supply chain disruptions made it difficult for businesses 'to obtain the resources they needed' and that 'salaries and wages' rose due to 'The Great Resignation'. These conditions would lead actual costs to be higher than budgeted costs.

Inflation may cause adverse revenue variances for a business. This is because if consumers have to pay more for many of the basic necessities they buy, then they will 'direct more of their spending on necessity goods'. This would mean that businesses that produce goods that are not considered necessities, such restaurants or entertainment services, may see lower revenues than expected.

Explain is an AO2 level command term, requiring a detailed account including reasons or causes. Explain *why*, explain *how*.

- Your response must include an explanation of the impact on income and on costs to access full marks.
- To achieve full marks, you must always include theory and application to the case study in your responses to the **explain command term**.

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2 section questions

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Question 1

A 1 favourable va... ✓ occurs when the budgeted expenditure is higher than the actual expenditure.

Accepted answers and explanation

#1 favourable variance

Question 2

Which of the following is the correct description of a favourable profit variance?

1. Favourable profit variance is when actual profit is greater than budgeted profit. ✓
2. Favourable profit variance is when actual profit is lower than budgeted profit.
3. Favourable profit variance is when actual profit is equal to budgeted profit.
4. Favourable profit variance is when actual profit is greater than actual revenue.

Explanation

A situation where actual profit is greater than the budgeted profit is a favourable profit variance.

3. Finance and accounts / 3.9 Budgets (HL)

The importance of budgets and variance analysis in decision - making

The importance of budgets and variances (HL)

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

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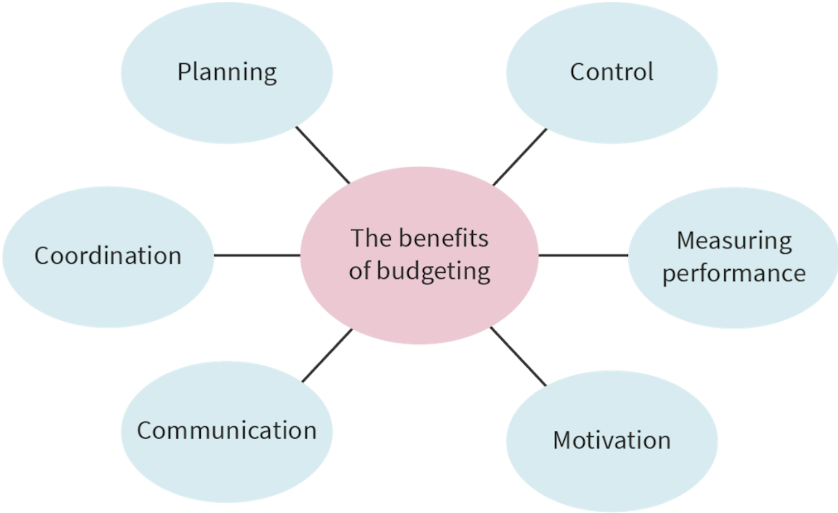

Figure 1. The importance of budgets and variance analysis for a business.

More information for figure 1

The diagram illustrates the benefits of budgeting, represented as a central circle labeled "The benefits of budgeting." Connected to this central idea are six surrounding circles, each labeled with a specific benefit. The benefits are:

1. Planning - located at the upper left.
2. Control - positioned at the upper right.
3. Measuring performance - on the right.
4. Motivation - at the lower right.
5. Communication - at the lower left.
6. Coordination - on the left.

Each of these elements is connected to the central idea with lines, forming a symmetrical layout. This visual structure emphasizes how each benefit is an integral part of the overall concept of budgeting.

[Generated by AI]

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.

Student view

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.

Student view

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?

Overview
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2 section questions

Question 1

Budgets are important for many reasons. Which of the following is **not** considered a reason why budgets are important?

1. Budgets can inform shareholders of how dividends will be allocated. ✓
2. Budgets can motivate managers and employees to meet objectives efficiently.
3. Budgets can encourage coordination between departments to ensure objectives are met.
4. Budgets can be used to assess the performance of managers who manage budgets to reach business objectives.

Explanation

Budgets are used for motivating, coordinating and performance assessment. However, budgets are internal documents and are not used to report dividend allocation. A statement of profit or loss reports dividend allocation.

Question 2

1 Variance ✓ analysis is used to adjust future budgets based on the differences between planned and actual income and expenditures in previous budgets.

Accepted answers and explanation

#1 Variance

3. Finance and accounts / 3.9 Budgets (HL)

Terminology exercise

Student
view

Overview
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Check that you understand the terminology used in this subtopic by dragging the correct word into each space.

A ______ can be defined as a tool to aid the planning, control, coordination and monitoring of a business's income and expenditure over a period of time.

A business may prepare two types of budget. The first is for an area of the business that generates revenue, which is called a ______. Areas of the business that do not generate any income are referred to as ______.

A ______ is used to compare a business's budgeted income and expenditure figures with the actual figures over a period of time. The variance analysis compares the forecast with reality. When this comparison is made, there are three possible outcomes. The first possible outcome is ______ variance, which occurs when the actual revenue and expenditure figures are beneficial for the business. The second possible outcome is ______ variance, which occurs when the actual figures are negative for the business. And the third possible outcome is when there is ______, which is when the budgeted figures align with the actual figures.

variance analysis | no variance | profit centre | a favourable | budget | an adverse | cost centres

Check

Interactive 1. Budgets and Variance Analysis.

3. Finance and accounts / 3.9 Budgets (HL)

Section Student... (0/0) Feedback Print (/study/app/business-hl/sid-351-cid-762729/book/terminology-exercise-id-39336/print/) Assign

Checklist

Section Student... (0/0) Feedback Print (/study/app/business-hl/sid-351-cid-762729/book/checklist-id-39354/print/) Assign

What you should know

By the end of this subtopic, you should be able to:

- define the following terms: (AO1)
  - budget
  - profit centres

Student view

Overview
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- cost centres
- variance analysis
- favourable variance
- adverse variance

- distinguish between cost centres and profit centres (AO2)
- explain the roles of cost centres and profit centres (AO2)
- explain and construct a budget (AO2, AO4)
- explain and calculate variances (AO2, AO4)
- explain the importance of budgets and variances in decision-making (AO2)

3. Finance and accounts / 3.9 Budgets (HL)

Reflection

Section Student... (0/0) Feedback Print (/study/app/business-hl/sid-351-cid-762729/book/reflection-id-48327/print/) Assign

Teacher instructions

The goal of this section is to encourage students to pause at the end of the subtopic and to reflect on their learning. Students can use the questions provided below to guide their reflection. The questions encourage students to look at the bigger picture and to consider how the subtopic's contents might have impacted the way they view the subject.

The following table shows you how each prompt aligns to the DP *Business management guide*:

Prompt #	Syllabus alignment
1	**Concept:** Sustainability
2	**Learner profile:** Reflective
3	**Concept:** Creativity

Students can submit their reflections to you by clicking on 'Submit'. You will then see their answers in the 'Insights' part of the Kognity platform.

Student view

Section Student... (0/0) Feedback Print (/study/app/business-hl/sid-351-cid-762729/book/budgets-and-variance-analysis-in-decision-making-id-39335/print/) Assign

Reflection

In this subtopic you learned about budgets and budgeting.

Take a moment to reflect on your learning so far. You can use the following questions to guide your reflection. If you click 'Submit', your answers will be shared with your teacher.

1. Try to recall a big event in your country or your area (sports, fair, celebration). Did the event manage to stay within the proposed budget? Why or why not?
2. What unpredictable factors (inflation, political change, currency fluctuations, etc.) may make it difficult for a business to stick to a budget?
3. Budgeting often relies on predictions and assumptions about the future. Is it ever possible to create a realistic budget?

Once you submit your response, you won't be able to edit it.

0/2000

Submit

Rate subtopic 3.9 Budgets (HL)

Help us improve the content and user experience.

Student view