USING BUDGETS

The Role of Budgets – "Budgetary Control"

A budget is a **financial plan** for the future concerning the revenues and costs of a business. However, a budget is about much more than just financial numbers.

Budgetary control is the process by which **financial control** is exercised within an organisation.

Budgets for income/revenue and expenditure are prepared in advance and then compared with actual performance to establish any **variances**.

Managers are responsible for controllable costs within their budgets and are required to take remedial action if the adverse variances arise and they are considered excessive.

There are many management uses for budgets. For example, budgets are used to:

- Control income and expenditure (the traditional use)
- Establish priorities and set targets in numerical terms
- Provide direction and co-ordination, so that business objectives can be turned into practical reality
- Assign responsibilities to budget holders (managers) and allocate resources
- Communicate targets from management to employees
- Motivate staff
- Improve efficiency
- Monitor performance

Whilst there are many uses of budgets, there are a set of guiding principles for good budgetary control in a business.

In an effective budget system:

- Managerial responsibilities are clearly defined – in particular the responsibility to adhere to their budgets
- Individual budgets lay down a plan of action
- Performance is monitored against the budget
- Corrective action is taken if results differ significantly from the budget
- Departures from budgets are permitted only after approval from senior management
- Unaccounted for variances are investigated

Variances and "management by exception"

A key word to understand when you are looking at budgets is **"variance"**

A variance arises when there is a **difference between actual and budget figures**

Variances can be either:

- **Positive/favourable** (better than expected) or
- **Adverse/unfavourable** (worse than expected)

A **favourable variance** might mean that:

- Costs were lower than expected in the budget, or
- Revenue/profits were higher than expected

By contrast, an **adverse variance** might arise because:

- Costs were higher than expected
- Revenue/profits were lower than expected

Should variances be a matter of concern to management? After all, a budget is just an estimate of what is going to happen rather than reality. The answer is – it depends.

The significance of a variance will depend on factors such as:

- Whether it is positive or negative – adverse variances (negative) should be of more concern
- Was it foreseen?
- Was it foreseeable?
- How big was the variance - absolute size (in money terms) and relative size (in percentage terms)?
- The cause
- Whether it is a temporary problem or the result of a long term trend

"**Management by exception**" is the name given to the process of focusing on activities that require attention and ignoring those that appear to be running smoothly

Budget control and analysis of variances facilitates management by exception since it highlights areas of business performance which are not in line with expectations.

Items of income or spending that show no or small variances require no action. Instead concentrate on items showing a large adverse variance.

Are all adverse variances bad news?

Here is a point that students often find hard to understand – or believe!

An adverse variance might result from something that is good that has happened in the business.

For example, a budget statement might show higher production costs than budget (adverse variance). However, these may have occurred because sales are significantly higher than budget (favourable budget).

Remember, it is the cause and significance of a variance that matters – not whether it is favourable or adverse.

Variances illustrated

Consider the following budget statement:

Item	Budget	Actual	Variance	Favourable
	£'000	£'000	£'000	or Adverse
SALES REVENUE				
Standard product	75	90	15	F
Premium product	30	25	-5	A
Total sales revenue	105	115	10	F
COSTS				
Wages	35	38	3	A
Rent	15	17	2	A
Marketing	20	14	-6	F
Other overheads	27	35	8	A
Total costs	97	104	7	A
Profit	8	11	3	F

What do the numbers in the budget statement tell us?

Looking at the sales revenue section, you can see that actual sales of standard product were £15k higher than budget – this is a positive (favourable) variance.

Turning to the costs section, actual wages were £3k higher than budget – i.e. an adverse (negative) variance.

Overall, the profit variance was positive (favourable) – i.e. better than budget

Problems and limitations of using budgets

Whilst budgets are widely used to in business, you should appreciate that they have some important limitations. In particular:

- Budgets are only as good as the data being used to create them. Inaccurate or unreasonable assumptions can quickly make a budget unrealistic
- Budgets can lead to inflexibility in decision-making
- Budgets need to be changed as circumstances change
- Budgeting is a time consuming process – in large businesses, whole departments are sometimes dedicated to budget setting and control
- Budgets can result in short term decisions to keep within the budget rather than the right long term decision which exceeds the budget
- Managers can become too preoccupied with setting and reviewing budgets and forgetting to focus on the real issues of winning customers

Budgets can also create some behavioural challenges in a business

- Budgeting has behavioural implications for the motivation employees
- Budgets are de-motivating if they are imposed rather than negotiated
- Setting unrealistic targets adds to de-motivation
- Budgets contribute to departmental rivalry - battles over budget allocation
- Spending up to budget: it can result in a "use it or lose it" mentality - spend up to the budget to preserve it for next year
- Budgetary slack occurs if targets are set too low
- A "name, blame and shame" culture can develop - but managers should be answerable only for variations that were under their control

Guided Revision Questions

	Marks
Define the term "variance"	2
Explain what is meant by the term "budgetary control"	2
What is the difference between historical and zero-based budgeting	4
List three advantages of using budgets	4
List three disadvantages of using budgets	4
Outline two ways in which a favourable variance may arise	4
Explain how a variance is calculated	4
State two possible causes of a favourable sales variance	4
State two possible causes of an adverse cost variance	4
Why is it important for a business to set a budget?	5
Outline three problems a business faces when setting a budget	6
Outline three principals of effective budgetary control	6
Explain why it is important that management focus on large adverse variances	6

Explain why a favourable variance might not necessarily be good news for a business	6
Outline three limitations with using budgets	6
Explain two reasons why an adverse cost variance might not be a signal of poor management by the budget holder	6
Explain how an effective system of budgetary control can help business managers in their decision-making	8
Discuss whether the benefits of budgeting outweigh the disadvantages to a business	10