

Chapter 32. Budget

Cambridge International
Business AS level
Finance and accounting

Chapter overview



the meaning and purpose of budgets and the benefits and drawbacks of their use



the meaning, calculation and interpretation of variances.

The meaning and purpose of BUDGET

- Budgets are **financial plans**.
- Budgets should be set for **sales**, **revenue** and **costs**.
- It is usual for each cost centre and profit centre to have budgets set for the next 12 months, broken down on a month-by-month basis.
- **If no plans:**
 - be without a **direction** or purpose
 - be unable to **allocate the scarce resources** of the business effectively
 - have demotivated employees with no plans or targets to work towards
 - be unable to **measure its progress** by measuring the plans against actual performance.



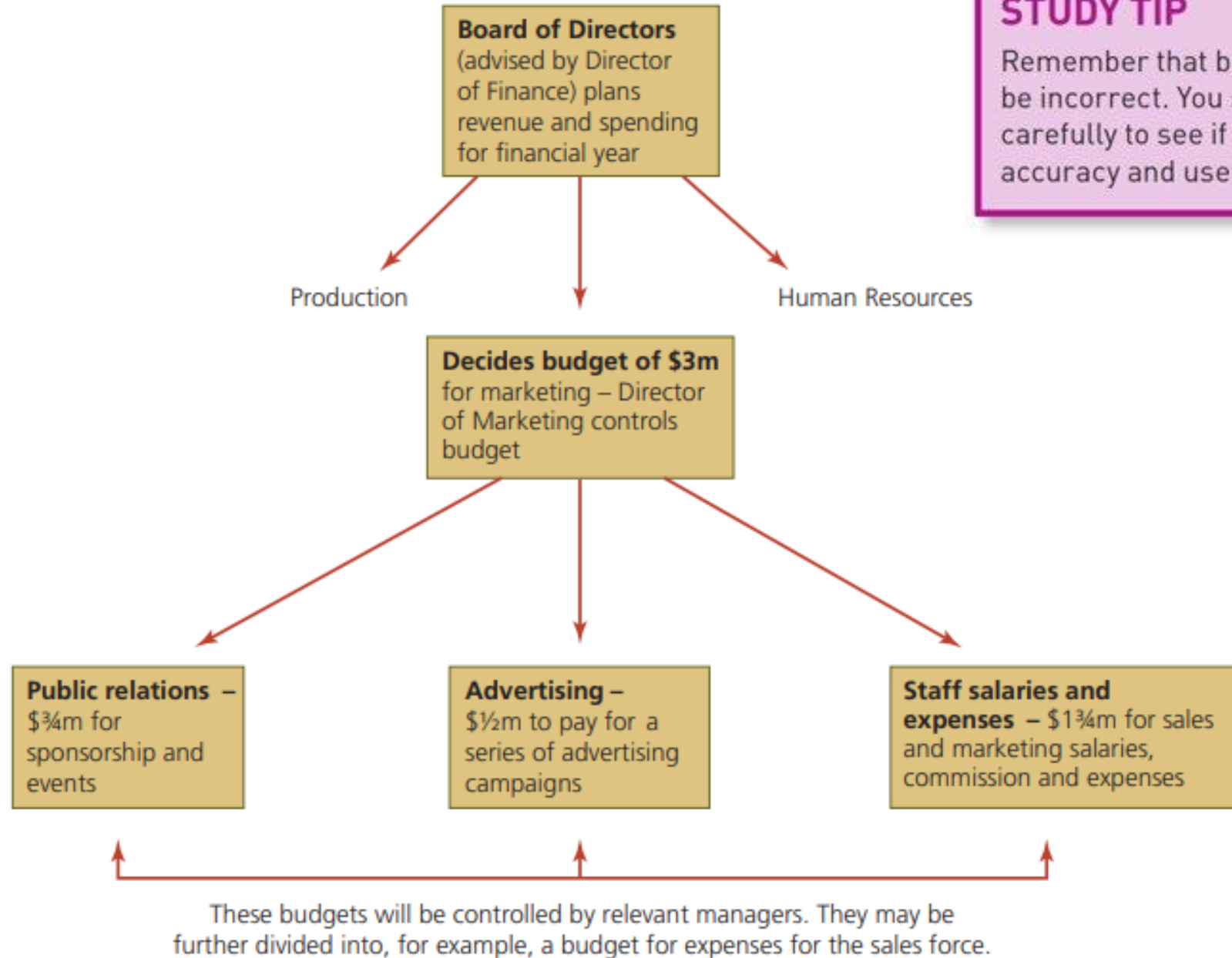
Benefits and Drawbacks of using BUDGETS

1. **Monitoring and controlling** - not overspend, spend only the budgeted amount - **budget-holder**
 2. **Effective allocation of resources** – which area more important...
 3. **Motivate employees** – **delegated budget**
 4. **Setting targets to be achieved** – sales revenue target is motivation
 5. **Coordination** – between departments
 6. **Measuring and assessing performance** – *variance analysis*
-
1. **Training on budgets** - Setting and keeping to budgets is not easy /delegated budget/
 2. **Focus on the short term** – long-term vs short term consequences/causes
 3. **Lack of flexibility** - unrealistic=>demotivate the budget holder and other employees
 4. **Unnecessary spending** - If underspent => unnecessarily spend
 5. **Budgets for new projects** - Setting budgets for big new projects is very difficult and often inaccurate.

Budgeting is NOT a forecast!!!, it's more likely target

STUDY TIP

Remember that budgets are forecast data and may be incorrect. You should read any case study material carefully to see if there is any evidence about its likely accuracy and use this to help to develop your answers.



▲ **Figure 5.22** An example of using budgets within a company

CASE STUDY

Alibaba

The Alibaba Group was founded in 1999 by 18 people led by Jack Ma, a former English teacher from Hangzhou, China. Its founders started the company to support small businesses, to help small enterprises to compete more effectively in China and globally. Initially the company created online marketplaces enabling buyers and sellers to meet and buy and sell products. By 2019, the company had grown very rapidly and employed 102 000 people, earned revenues totalling \$56.15 billion and profits amounting to just under \$12 billion.

By 2020, Alibaba provided a wide range of services. Its websites provide:

- sales services for businesses and consumers
- services for electronic payments
- search engines for shopping
- cloud computing services.

Alibaba owns and operates a wide variety of different businesses throughout the world. For example, in 2018, Daraz, a Pakistani online store, was bought by the Alibaba Group, making the South Asian e-commerce platform an important part of Alibaba's global operations.

The Alibaba Group aims to grow quickly. It has set itself some important targets to ensure its continued growth. Three important targets are:

- to have 2 billion global customers by 2036
- to create a further 100 million jobs
- to support over 100 million profitable businesses on its websites.

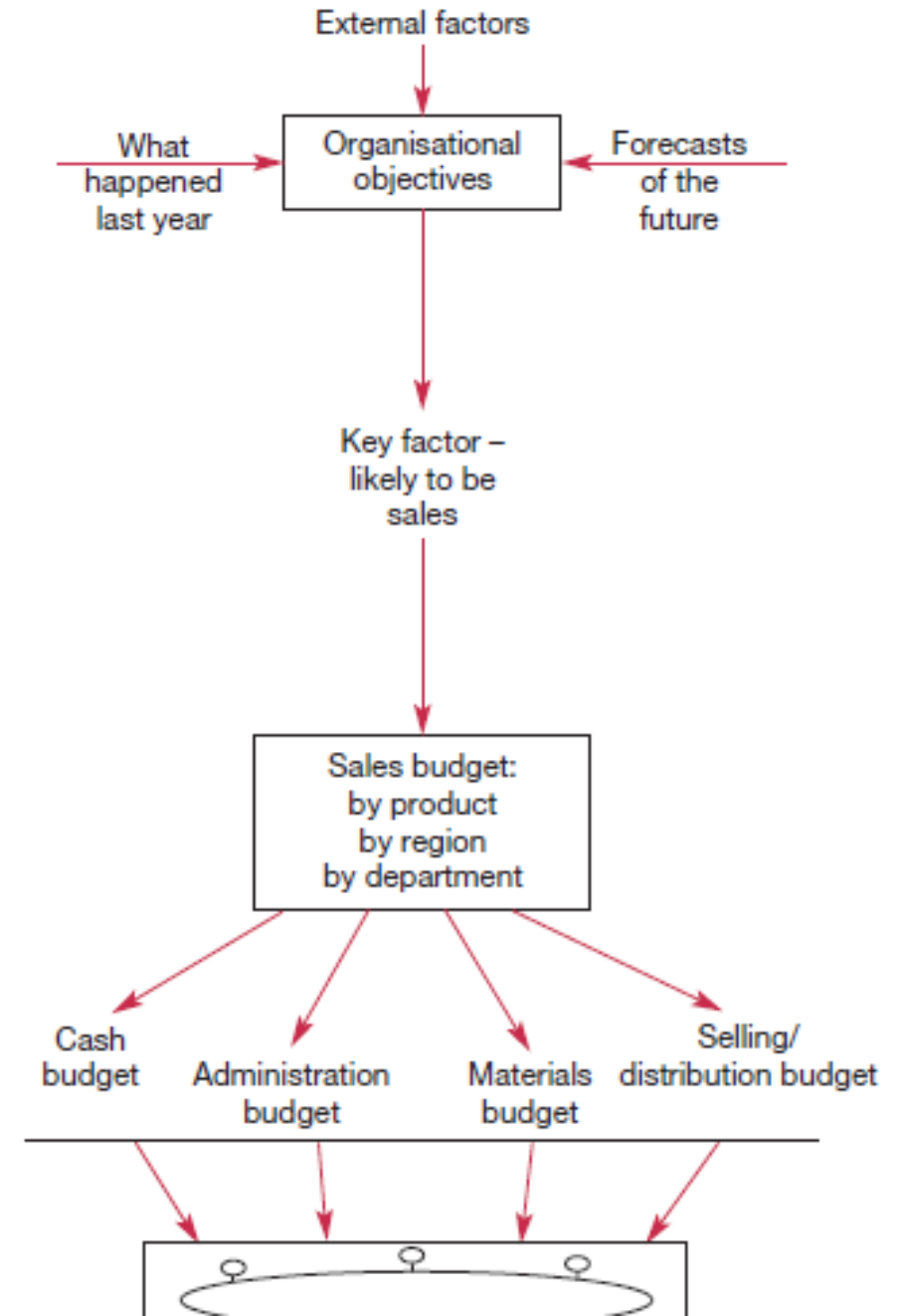
Questions

- 1 Analyse **two** reasons why budgeting would be important to Alibaba while it is growing quickly. [8]
- 2 'It is impossible for Alibaba to draw up accurate budgets.' Evaluate this view. [12]

- The managers who are to be held responsible for fulfilling the budget should be involved in setting the budget.
- This will create more motivated, more accountable managers

See the graph for common Budgeting process!

How budgets are commonly prepared



Methods of setting the budget

- **Incremental budgeting** – adjust the budget, based on previous year's budget
 - Overspending, 'massage' the data, not encourage risk-taking...
- **Zero budgeting** – start the budgeting process from zero, each year
 - Accurately, avoid creeping up, effectively allocating /manager negotiating skills/, time consuming, but sales budget!!!
- **Flexible budgeting** - if there is variance in the output for example, adjust the direct cost according to “budgeted” amount, and not actual amount

GLOSSARY TERMS

Incremental budgeting is a process where budget figures are minor changes from the preceding period's budgeted or actual data.

A **flexible budget** is a budget that is designed to change along with the sales volume or production levels.

GLOSSARY TERMS

A **budget holder** is responsible for the use and management of a particular budget.

Zero budgets exist when budgets are automatically set at zero and budget holders have to argue their case to receive any funds.

Methods of setting the budget level

Flexible budgeting - removes at least some of the effects of the external factors...

▼ Table 5.15 An example of a flexible budget

Normal budgets (\$000s)			Flexible budgets (\$000s)		
	Budget	Actual	Budget	Flexed budget	Actual
Sales revenue	750	600	750	600	600
Overheads	200	204	200	200	204
Labour	180	162	180	144	162
Materials	220	201	220	176	201
Other costs	60	53	60	48	53
Total costs	660	620	660	568	620
PROFIT	90	(20)	90	32	(20)

- Need to *flex* the budget
- Flexible budgeting is more motivating for managers, because if the number is in reverse (output, and direct material cost is more than budgeted), they get to flex the budget
- Flexed targets are more realistic

Uses of Budgeting



MEASURING
PERFORMANCE



ALLOCATING RESOURCES



CONTROLLING AND
MONITORING BUSINESS

Budget and budgeting

Budgets and Budgeting (Introduction)

- https://www.youtube.com/watch?v=uyK_Dv9Bmb4

Variance analysis

- <https://www.youtube.com/watch?v=ntSZl24-12g>
- <https://www.youtube.com/watch?v=3VnOhCr6FHE>


Variance analysis

A variance is the difference between a budget and the actual figures achieved at the end of the budget period.

- Measuring performance /expenditure, sales and profit/
- Finding out the reasons - set more realistic budgets and take better decisions



IF THE VARIANCE HAS HAD THE EFFECT OF INCREASING
PROFIT ABOVE BUDGET, THEN IT IS CALLED A
FAVOURABLE VARIANCE.

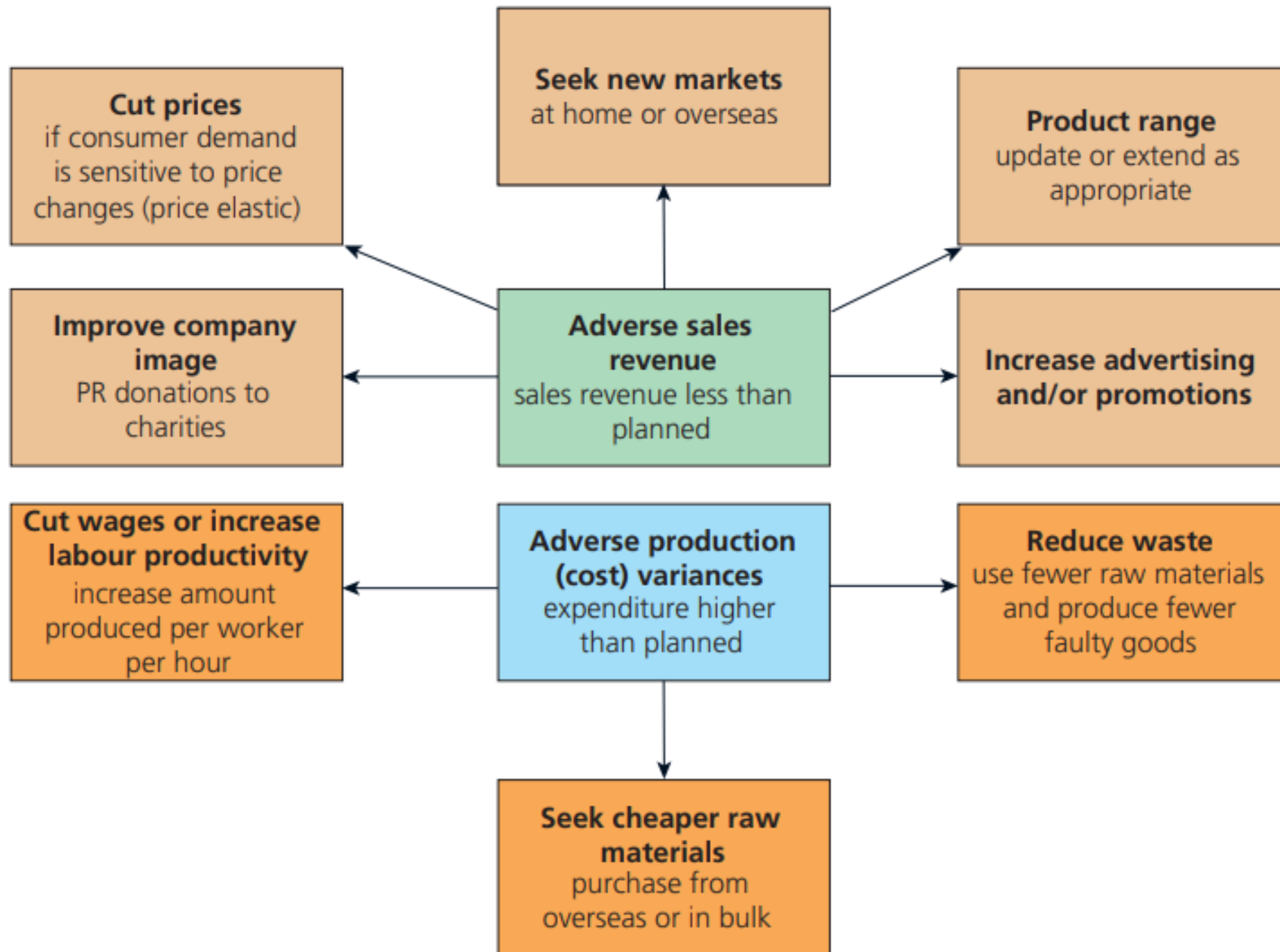


IF THE VARIANCE HAS HAD THE EFFECT OF
REDUCING PROFIT BELOW BUDGET, THEN IT IS
CALLED AN **UNFAVOURABLE OR ADVERSE
VARIANCE**

Adverse variances	Favourable variances
<p>Causes:</p> <ul style="list-style-type: none"> ■ Sales revenue is below budget <i>either</i> because units sold were less than planned for <i>or</i> the selling price had to be lowered due to competition. ■ Actual raw material costs are higher than planned for <i>either</i> because output was higher than budgeted <i>or</i> the cost per unit of materials increased. ■ Labour costs are above budget <i>either</i> because wage rates had to be raised due to shortages of workers <i>or</i> the labour time taken to complete the work was longer than expected. ■ Overhead costs are higher than budgeted, perhaps because the annual rent rise was above forecast. 	<p>Causes:</p> <ul style="list-style-type: none"> ■ Sales revenue is above budget due to higher-than-expected economic growth <i>or</i> problems with one of the competitor's products. ■ Raw material costs are lower <i>either</i> because output was less than planned <i>or</i> the cost per unit of materials was lower than budget. ■ Labour costs are lower than planned for <i>either</i> because of lower wage rates <i>or</i> quicker completion of the work. ■ Overhead costs are lower than budgeted, perhaps because advertising rates from TV companies were reduced.

Table 33.1 Possible causes of adverse and favourable variances

- Managers need to pay attention to BOTH **favourable** and **adverse** variations!
- Budgeting might be lengthy and costly process, but it is crucial for company's success!



Key words, phrases

Favourable variances

Эерэг зөрүү

Adverse/ infavourable variances

Сөрөг зөрүү

Identify the causes of the *deviation*

Зөрүү гарсны учир шалтгааны
тодруулах

Increment in the previous year's budget

Өөрчлөлт оруулах

Flex the budget to the actual output

Тохируулах,

STUDY TIP

Questions asking you to analyse variances are common in Business exams. It is important for you to identify those areas in which *major* differences between planned and actual expenditure or revenue have occurred. This will help to give a focus to your answer. It is also very likely that you will be asked to suggest possible causes (or cures) for the variances.

Variance analysis at Oasis Cookers Ltd

Oasis Cookers Ltd makes gas and electric ovens. The business has a good reputation for quality products. These are sold through a number of selected retailers who have agreed to display and market the ovens in ways that differentiate them from cheaper models. The national economy is experiencing a downturn with no economic growth. The government has been forced to increase interest rates to control cost inflation and this has contributed to an appreciation of the currency's exchange rate. Foreign oven imports are falling in price because of this. The management of Oasis Cookers Ltd are studying the latest variance analysis results:

\$000	Budgeted figures	Actual figures	Variance
Revenue	165	150	
Cost of materials	80	70	
Labour costs	22	23	
Gross profit	63	57	
Overheads	40	43	
Operating profit	23	14	

[42 marks, 1 hour]

- 1 Calculate the variances and indicate whether they are favourable or adverse variances. [6]
- 2 Explain **two** possible reasons for the variances in:
 - a sales revenue [4]
 - b labour cost. [4]
- 3 Evaluate **two** ways in which the management of Oasis Cookers could respond to these variance-analysis results to improve performance of the business. [10]
- 4 The managers of Oasis Cookers asked for additional information from the management accountants. In particular, they asked for a breakdown of the overhead cost variances:

Overhead costs \$000	Budgeted figures	Actual figures	Variance
Promotion and distribution	8	6	
Administration	9	8	
Production	22	27	
Personnel	1	2	

- Calculate the variances for each type of overhead cost and indicate whether they are favourable or adverse. [4]
- 5 Evaluate the benefits of setting budgets and using variance analysis to manufacturing businesses such as Oasis Cookers Ltd. [14]

BMW's new factory in Mexico

In 2019, the German car manufacturer, BMW, opened a new car factory in Mexico, approximately 400 km north of the capital city, at San Luis Potosí. The new factory uses ports on both the west and east coasts of Mexico for transporting components and to export finished vehicles.

The company has invested more than US\$1 billion in the new production location. The plant, which already employs 2500 people, has a high proportion of Mexican employees who have been trained in BMW's approach to production.

The factory at San Luis Potosí will build BMW's most successful model series: the BMW 3 Series Sedan. This popular car has set the standard for performance, efficiency and design, and the company expects high sales of the new model. The new model does, however, face intense competition from the Audi 4 and Mercedes C class and others.

In its new factory, robots and employees work directly alongside one another, making effective use of the strengths of each. Production began in April 2019, with the plant producing 240 cars per day by October. In 2020, the factory's production had risen to 580 cars per day, moving towards its annual production capacity of 175 000 units.



▲ **Figure 5.24** Use of robots on BMW's production line means that fewer workers are used.

Questions

- 1 Analyse **one** possible factor that might result in the new factory recording adverse variances. [4]
- 2 'The "intense competition" that the BMW 3 series will face is the most important reason for BMW drawing up budgets for the new factory.' Evaluate this view. [12]

ADL is a television company in Argentina which produces and broadcasts a range of programmes and operates three satellite channels. It is particularly noted for producing documentaries and popular drama series. The market for making and broadcasting television programmes is growing rapidly in Argentina and other Spanish-speaking countries, although rates of growth vary widely over time. Last year's growth in sales was 11.5 per cent, while the year before it was just 2.9 per cent.

The company's managers have just been reviewing its financial performance, including analysing its performance against budgets. Some of the data they considered is shown in Table 5.18 below.

One of ADL's managers said she believed that this budgetary data provided the best possible measure of ADL's performance.

▼ **Table 5.18** ADL's budget data

	Budget (\$m)	Actual (\$m)	Variance
Sales revenue	3 347.8	3 999.4	
Labour costs	1 552.2	1 840.3	288.1 A
Materials costs	205.7	201.6	4.1 F
Other costs	630.1	916.6	286.5 A
Overheads	597.0	602.4	5.4 A
Total costs	2 985.0	3 560.9	
Profit/(loss)	362.8	438.5	

Questions

1 Calculate the variances for the company's total sales revenue, total costs and profits, stating whether each is adverse or favourable. [6]

2 One manager believed that 'this budgetary data provided the best possible measure of ADL's performance'. Evaluate this view. [12]

TEST YOUR LEARNING

Short answer questions

- 1 Define the terms:
 - a 'sales revenue budget' [2]
 - b 'expenditure budget'. [2]
- 2
 - a Explain **one** reason why setting budgets may lead to an improvement in the motivation of employees. [3]
 - b Budgets are short-term in nature. Explain **one** reason why this might be a problem for a business. [3]
- 3
 - a Explain **one** reason why it might be difficult for a business to forecast its sales accurately. [3]
 - b Explain **one** way in which a change in the economy may make a business' budgets inaccurate. [3]
- 4
 - a Define the term 'flexible budget'. [2]
 - b Explain **one** reason why a business might decide to use a flexible-budgeting system. [3]
- 5
 - a Define the term 'zero budgets'. [2]
 - b Explain **one** reason why a business might decide to use a zero-budgeting system. [3]
- 6
 - a Define the term 'variance analysis'. [2]
 - b Explain **one** reason why it is important for managers to monitor budgets once they have been set. [3]
- 7 A business has the following budgetary data:
▼ **Table 5.19**

	Budget (\$m)	Actual (\$m)
Sales revenue	254.75	295.10
Total costs	222.86	256.84

Calculate its profit variance and identify whether it is adverse or favourable. [4]
- 8 Explain **one** difference between adverse and favourable variances. [3]
- 9
 - a Explain **one** factor that may lead to a business having adverse variances on its profits. [3]
 - b Define the term 'incremental budgeting'. [2]
- 10 Explain **one** way in which budgets might help a large multinational company to manage its finances efficiently. [3]

Data response question

Nadal Ltd

Nadal Ltd's cafés sell budget-priced drinks such as coffee and tea, as well as tapas and light meals. The company has succeeded despite, or maybe because of, the weak economic position in Spain. The company's brand name is associated with low prices and value for money. The company plans to expand using finance raised mainly through loans.

Last year, Nadal Ltd opened its 59th café in Ronda, southern Spain. This is its first café in this part of Spain and the company has only conducted secondary market research. The new manager in Ronda has no experience of cafés or financial planning, but they are experienced in retail and in managing people. Despite this, sales have risen steadily, if slowly, and customer feedback is positive.

▼ **Table 5.20** Nadal Ltd, Ronda Café – budget figures for first three months of trading

	Budget (\$)	Actual (\$)
Sales revenue	11 500	10 990
Indirect costs	4 250	4 300
Direct costs	6 890	6 900
Profits	360	(210)

Questions

- 1 Analyse **two** problems that Nadal Ltd faced in setting its budgets for the new café. [8]
- 2
 - a Calculate the profit variance for the first three months of trading for the Ronda café. [3]
 - b Evaluate whether the benefits of drawing up budgets outweigh the drawbacks to Nadal Ltd. [12]
- 3 'The managers at Nadal Ltd should be pleased with the performance of its café in Ronda.' Evaluate this view. [12]