BUDGETs – Variance analysis

A budget is an agreed plan that sets out in quantities or financial terms the policy to be followed and the forecast outcomes, for a period of time.

The period of time can be for a day, a week, a month, a year, a decade.

However, while a budget is set once for a period of time, an important part of the work of budgeting is to monitor what happens as the budget is put in to place and the actual results are collected. The comparison of the actual results with the budget is an essential element of budgetary control.

This comparison is called **variance analysis**

Calculating variances

The same formula is always used, and what is important is the **order:**

**variance = budget figure - actual figure**

For example:

A student earns £50 per week and plans to earn in the six weeks to Christmas £300.

* However, one week due to illness they earn £35, what is the budget variance?

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| variance | = | budget figure | - | actual figure |
| £15 | = | £50 | - | £35 |

The variance to budget is ADVERSE, because the actual cash is *less* than the budget.

* The following week the student works overtime and earns £75, what is the budget variance?

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| variance | = | budget figure | - | actual figure |
| -£25 | = | £50 | - | £75 |

The variance to budget is FAVOURABLE, because the actual cash is *more* than the budget.

A student plans to use some of their cash to buy two Christmas presents.

* The first present is budgeted for £20, but ends up costing £30, what is the budget variance?

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| variance | = | budget figure | - | actual figure |
| -£10 | = | £20 | - | £30 |

The variance to budget is ADVERSE, because the actual cash is *more* than the budget.

* The second present is budgeted for £40, but ends up costing £30, what is the budget variance?

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| variance | = | budget figure | - | actual figure |
| £10 | = | £40 | - | £30 |

The variance to budget is FAVOURABLE, because the actual cash is *less* than the budget.

So, what are the rules that we can follow from these examples:

1. The measurement is always against the budget, what was planned to happen.
2. If the actual result helps to achieve the budget, then the variance is FAVOURABLE, but if the actual result hinders the achievement of the budget the variance is ADVERSE.
3. We can apply these rules in the following way:

* Compared to the Budget are you measuring a revenue item (sales revenue, units sold, commission, capital)?

Yes! then if the actual variance is *more than* budget it is FAVOURABLE,  
or, if the actual variance is *less than* budget it is ADVERSE

Why? we assume that if everything else is equal, *more* revenue will help achieve the budget, but *less* revenue will make it harder to achieve the budget.

* Compared to the Budget are you measuring an expenditure item (raw materials, rent, wages)?

Yes! then if the actual variance is *more than* budget it is ADVERSE,  
or, if the actual variance is *less than* budget it is FAVOURABLE

Why? We assume that if everything else is equal, *less* expenditure will make it easier to achieve the budget, but *more* expenditure will make it harder to achieve the budget.

NOTE: how is profit treated, as revenue or expenditure?

Profit is treated the same way as a revenue item, So, if actual profit is greater than budgeted profit the variance is FAVOURABLE, while less profit than budgeted is an ADVERSE variance.

Some books show the minus sign as brackets, as in this revenue example

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| variance | = | budget figure | - | actual figure |
| (£10) | = | £20 | - | £30 |

Calculating variances - Exercises

Complete the last column in the table by filling in the size of the variance and stating whether it is favourable (F), or adverse (A)

|  |  |  |  |
| --- | --- | --- | --- |
| £ | Budgeted | Actual | Variance |
| Revenue |  |  |  |
| January | 12 | 13 |  |
| February | 14 | 15 |  |
| March | 13 | 12 |  |
| April | 15 | 16 |  |
| Costs |  |  |  |
| January | 10 | 12 |  |
| February | 12 | 14 |  |
| March | 14 | 14 |  |
| April | 15 | 13 |  |

Discus whether the business has performed well or poorly over the four month period January to April

|  |
| --- |
|  |
|  |
|  |
|  |

Complete the last column in the table by filling in the size of the variance and stating whether it is favourable (F), or adverse (A)

|  |  |  |  |
| --- | --- | --- | --- |
| £ | Budgeted | Actual | Variance |
| Revenue |  |  |  |
| Q1 | 1.2 | 1.5 |  |
| Q2 | 1.3 | 1.3 |  |
| Q3 | 1.1 | 1 |  |
| Q4 | 1.6 | 1.4 |  |
| Costs |  |  |  |
| Q1 | 1 | 1.1 |  |
| Q2 | 1.1 | 1.2 |  |
| Q3 | 0.9 | 1.1 |  |
| Q4 | 1.4 | 1.6 |  |

Complete the missing values from the Budgeted and Actual columns, then complete the last column of the table and state whether the variance is favourable (F), or adverse (A)

|  |  |  |  |
| --- | --- | --- | --- |
| Annual budgeted and actual overheads for a biscuit manufacturer (£) | | | |
| Description | Budgeted | Actual | Variance |
| Rent | 60,000 | 60,000 |  |
| Rates | 5,500 | 5,500 |  |
| Insurance | 1,200 | 1,300 |  |
| Maintenance | 16,000 |  | 1000 |
| Distribution | 78,000 | 85,000 |  |
| Telephone |  | 1,600 |  |
| Administration | 64,000 |  | 2,000 |
| Accountancy fees | 4,500 | 4,700 |  |
| Depreciation |  | 20,000 | 0 |
| TOTAL | 250,900 | 255,100 |  |

Complete the missing values from the last column of the table and state whether the variance is favourable (F), or adverse (A)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Budgeted and actual cash flows for a carpet retailer for 2months (£) | | | | | | |
|  | JANUARY | | | FEBRUARY | | |
|  | Budgeted | Actual | Variance | Budgeted | Actual | Variance |
| Cash receipts | 25,000 | 25,600 |  | 26,000 | 27,100 |  |
| Cash Inflow | 25,000 | 25,600 |  | 26,000 | 27,100 |  |
| Purchases | 15,000 | 17,000 |  | 15,000 | 16,000 |  |
| Wages | 6,500 | 6,600 |  | 6,500 | 6,700 |  |
| Overheads | 2,000 | 2,100 |  | 2,000 | 1,800 |  |
| Cash outflow | 23,500 | 25,700 |  | 23,500 | 24,500 |  |
| Net cash flow | 1,500 | -100 |  | 2,500 | 2,600 |  |
| Opening balance | 4,000 | 4,000 |  | 5,500 | 3,900 |  |
| Closing balance | 5,500 | 3,900 |  | 8,000 | 6,500 |  |