DP IB Business Management: HL

Your notes

3.9 Budgets

Contents

Cost & Profit Centres

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An Introduction to Cost & Profit Centres

- **Tracking costs and revenues** becomes more **complex** as a business **grows**
- **Cost** and **profit centres** classify different parts of a business based on their **financial performance**

Cost Centres & Profit Centres

Type	Definition	Explanation

Cost Centre	▪ Business units or departments that are **responsible for incurring costs** but **do not generate revenue**	▪ Cost centres **track** and **manage expenses**
		▪ **Managers** can be held **accountable** for **controlling costs**
		▪ Examples include **functions** such as
		  ▪ Human resources
		  ▪ Administration
		  ▪ IT Support

Profit Centre	▪ Business units or departments that **generate revenue and incur costs**	▪ Profit centres are expected to **cover their costs** and **make a profit** in their own right
		▪ **Managers** are fully **accountable** for their **overall financial performance**
		▪ Examples include **units** such as
		  ▪ Sales departments or regions
		  ▪ Specific product lines
		  ▪ Retail outlets

The Roles of Cost & Profit Centres

- **Multi-location** businesses use cost centres and profit centres to **measure** and **improve** their **financial management**

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- **High-performing** functions or business units can be **identified and rewarded**
- **Low-performing** functions can be **monitored closely**
- Cost centres and profit centres therefore fulfil a number of important roles

Diagram: the main roles of cost & profit centres

Cost and profit centres help improve organisation and control, support budget autonomy and accountability and can improve motivation

Organisation and control

- Managers can set and monitor **budgets** for different sections of the business
- Performance can be analysed and compared over time

Budget autonomy

- Budget holders can **make their own financial decisions** without the need to consult business leaders
- **Focused** decisions can be made **quickly**

Accountability

- Budget holders' **performance** can be measured against their management of costs and revenues
- Can support the **appraisal** processes

Motivation

- **Delegation** of budgets can **drive budget holders** to make effective financial decisions
- Good performance can be recognised and **rewarded**

Advantages & Disadvantages of Cost & Profit Centres

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- The advantages and disadvantages of cost and profit centres can vary according to the **size** and **type** of business
- **Multi-unit businesses**, those with **numerous product lines** and **complex businesses** may benefit extensively from using cost and/or profit centres

Advantages & Disadvantages of Cost and Profit Centres

Advantages	Disadvantages
▪ **Can assess the performance of individual parts of the business** ▪ Managers can concentrate efforts on poor-performing areas ▪ Rewards for good performance can be targeted	▪ **May cause rivalry between different departments/units** ▪ Negative impact on professional relationships ▪ 'Win at all costs' culture may affect quality/customer service
▪ **Allows financial decisions to be made at a local level** ▪ Prices can be set according to local market conditions ▪ Effective control of costs by those given responsibility to actually spend business money	▪ **Not always straightforward to separate or allocate costs/revenues** ▪ Businesses with multiple product lines may not be able to accurately allocate costs between them
▪ **Allows for delegation of financial decision-making** ▪ Increased responsibility can motivate lower-level employees ▪ Increases the diversity/interest of job roles	▪ **Requires financial skills and training** ▪ Extra demands alongside a manager's core role ▪ Training requires investment/time away from work

Examiner Tips and Tricks

Many large businesses **operate both cost and profit centres**

- Supermarket retailers such as Carrefour and Aldi operate **profit centres** for individual or groups of stores
- They also operate **cost centres** for their head office functions such as Human Resources and Marketing

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Budgets & Variances

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An Introduction to Budgets

- A budget is a **financial plan** showing the business costs and revenue for a given time period
    - Budgets are set for the **whole business** and for individual **cost centres** or **profit centres**
    - Budgets are **set in advance** (**monthly, quarterly** or **annua)** and **monitored regularly**
    - The budget is usually closely aligned with the **business objectives**

Why Businesses use Budgets

Reason	Explanation
Planning & monitoring	▪ Businesses that use budgets are actively **planning ahead** ▪ Problems and their solutions may be considered and solved **in advance**
Control	▪ Frequent monitoring of budgets allows managers to **precisely control** their functional area ▪ Budgets support the setting and review of company or department **objectives**
Coordination & Communication	▪ Budgeting requires different parts of a business to operate as part of a **coordinated whole** ▪ Budgets may be **communicated throughout the organisation** to provide a framework for decision-making and communication
Motivation & Efficiency	▪ Budgets play an important role in **target-setting** and performance management which can be used by managers to **measure success** ▪ The allocation of budgets **spreads decision making** across the organisation acting as a **motivator** to the managers who control them ▪ Delegating budgets **frees up time for senior managers** as they do not need to authorise all financial decisions

Types of budgets

- Budgets are generally prepared using one of two methods

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- **Historical figure** budgets
- **Zero based** budgeting

A Comparison of Historical and Zero Budgeting Methods

Historical figure budgets	Zero based budgeting

▪ Budgets are usually **based on prior sales and costs data**
▪ They **allow for external factors** such as **Inflation** and other relevant economic indicators (e.g. **exchange rate** variations)
▪ The **most common approach** to budgeting which **delegates responsibility** for costs and revenue generation to departments or business units
	▪ Budgets are not **allocated** at all
	▪ **All spending must be justified**
	  ▪ **Time-consuming** as evidence to support spending decisions needs to be collected and presented
	  ▪ **Requires skilled and confident employees** to make persuasive spending/revenue generation decisions
	▪ Particularly useful where a business needs to **control costs closely**

Constructing a Budget

- The **master budget** consolidates all of the budgets delegated to **cost centres** or **profit centres** into one budget
- It is managed by the **Finance Director**

Diagram: common types of delegated budgets

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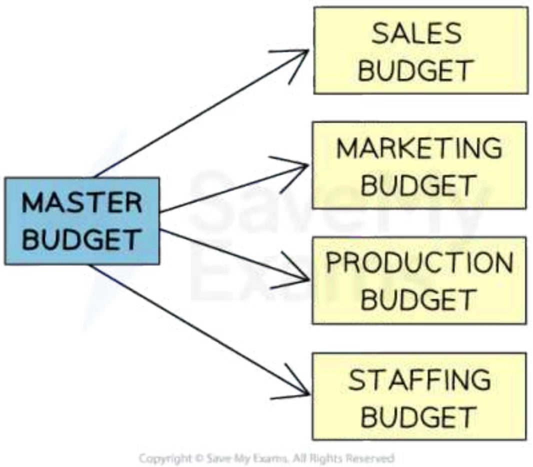


The Master Budget is a consolidation of delegated budgets such as Sales, Marketing, Production and Staffing

- **Sales budgets** forecast the volume of sales and expected sales revenue
- **Marketing budgets** plan finances allocated for marketing activities including market research, promotion and pricing tactics
- **Production budgets** plan the level of output, stock and overhead costs as well as aspects such as waste
- **Staffing budgets** plan the costs involved in employing workers including recruitment and training

Factors affecting the construction of budgets

- A range of factors are considered when determining budgets

Factors Affecting the Construction of Budgets

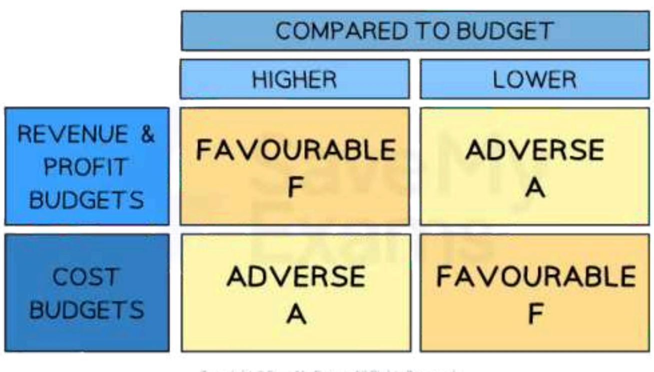
Factor	Explanation
Historical Data	▪ Previous years' performance determines the budget set ▪ A positive economic outlook may allow budgets to be increased
Availability of Finance	▪ Profitable businesses - or those able to raise finance - will be able to set more generous budgets
Benchmarking	▪ Budgets are based on activities of close rivals

	▪ For example, marketing budgets may be increased if a close competitor increases spending on advertising
Negotiation	▪ Budgets are discussed between budget holders/managers and the Financial Controller ▪ There may be some rivalry between business departments/units

Understanding Budget Variances

- A **budget variance** is a **difference between a figure budgeted and the actual figure achieved** by the end of the budgetary period (e.g. twelve months)
- **Variance analysis** seeks to determine the reasons for the differences in the actual figures and budgeted figures

Diagram: to illustrate favourable and adverse budget variances



Variance analysis identifies adverse and favourable budget outcomes

- A **favourable variance (F)** is where the **actual figure achieved is better than the budgeted figure**
  - A favourable variance in a **revenue or profit budget** is where the actual figure is **higher than the budgeted figure**
  - A favourable variance **in a costs budget** is where the actual **figure is lower** than the budgeted figure
  - **Examples** of favourable variances include
    - Actual wages less than budgeted wages
    - Actual sales volumes higher than budgeted sales volumes

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    - Expenditure on raw materials less than the budgeted figure
- An **adverse variance (A)** is where the **actual figure achieved is worse than the budgeted figure**
  - An adverse variance in a revenue or profit budget is where the actual figure is **lower** than the budgeted figure
  - An adverse variance in a costs budget is where the actual figure is **higher** than the budgeted figure
  - **Examples** of adverse variances include
    - Expenditure on fuel higher than the budgeted figure
    - Profit lower than budgeted
    - Actual marketing costs higher than budgeted marketing costs

Worked Example

Selected financial information for *Bunsens PLC* 2022

	£ m
Budgeted sales revenue	12,460
Actual sales revenue	13,718
Budgeted total costs	8,420
Actual total costs	10,627

Using the data, calculate the total profit variance for *Bunsen PLC* in 2022. You are advised to show your working (4)

Step 1 - Calculate the budgeted profit for 2022

£ 12,460 - £ 8,420

= £ 4,040 **(1)**

Step 2 - Calculate the actual profit for 2022

£ 13,718 - £ 10,627

= £ 3,091 **(1)**

Step 3 - Subtract the budgeted profit from the actual profit for 2022

£ 3,091 - £ 4,040

= £ 949 **(1)**

Step 4 - Identify the nature of the variance

In this case, the variance is adverse because the actual profit for 2022 is lower than the budgeted profit for 2022

The correct answer is £ 949 A (1)

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Responses to Budget Variances

- Once variances have been identified, a business should **carefully investigate the reasons why they have occurred** and take appropriate action, such as
  - Where **adverse cost variances** are identified a business may **seek alternative suppliers** or investigate ways to improve **efficiency**
  - Where **adverse sales variances** are identified a business may **review its marketing activities** to improve their effectiveness
  - Where **favourable cost variances** are identified a business may review key quality indicators such as the volume of returns or **wastage** levels to **ensure that output standards are being met**
  - Where **favourable sales variances** occur a business may **reward customer-facing staff** with performance based incentives

Examiner Tips and Tricks

Adverse variances are not always problematic

In some cases they may reflect a reasonable business response to a change in **market conditions** or **external factor**

For example, an **unexpected increase in demand** may require increased output

- Higher stock costs and energy use
- Increased wages
- Higher distribution costs

It is important to understand the context of variances before using them to support decision-making

Using Budgets & Variances in Decision-making

- Budgets and variance analysis play a **central role** in business financial management

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The Role of Budgets & Variance Analysis

Planning & Allocating Resources	Controlling & Monitoring
▪ Budgets support decisions on how to allocate resources such as staff ▪ Can identify need for **capital investment** ▪ Determines under- and over-performance so reallocation of resources can be arranged	▪ Budgets help to prevent overspending ▪ Maintains focus on generating profit ▪ Adverse variances can indicate poor manager performance ▪ Can take early steps such as training or **redeployment**
Measuring Performance	**Motivation**

▪ Budgets enable the business to:
    ▪ Judge the effectiveness of cost/revenue generation in different departments/units
    ▪ Compare financial performance in geographical regions
    ▪ Track financial plans over time
	▪ Budgets improve motivation by:
	    ▪ Rewarding effective budgetary performance
	    ▪ Providing a metric for employees to focus on
	    ▪ Increases job interest/challenge of budget holders

Difficulties of constructing budgets

- Budgeting requires **significant expertise** to be of genuine use to a business
- There are several **difficulties** associated with their construction

Diagram: the difficulties of budgeting

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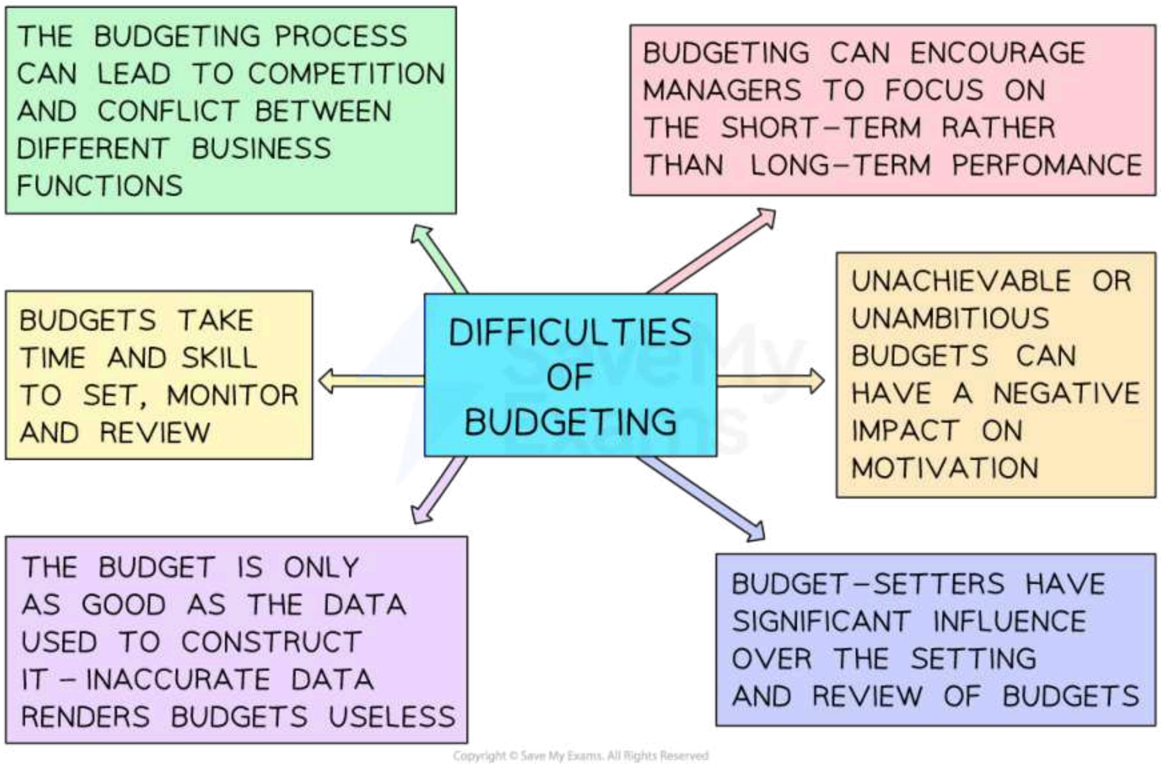

Budgets can be difficult to construct for a range of reasons

- Data must be **up to date, accurate and free of bias**
  - Sources of data must be selected carefully
  - **Those constructing budgets will require skills and relevant experience**
- Budgets can encourage managers to focus on the **short-term rather than the long-term success** of the business as budgets are usually set year on year
- **Conflict between budget holders** may arise, reducing the effectiveness of the business as a whole