

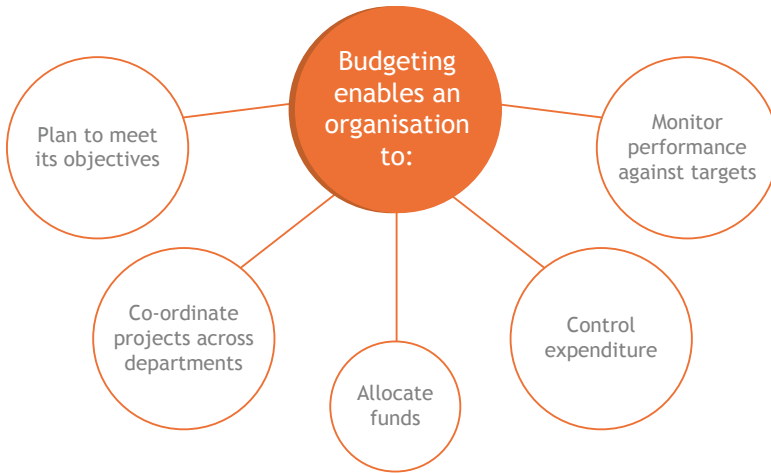
Chapter 11

Budgeting and Sales Variances

How do I draw up a budget?

A budget is a financial plan for income and expenditure, against which actual income and expenditure can be compared and evaluated.

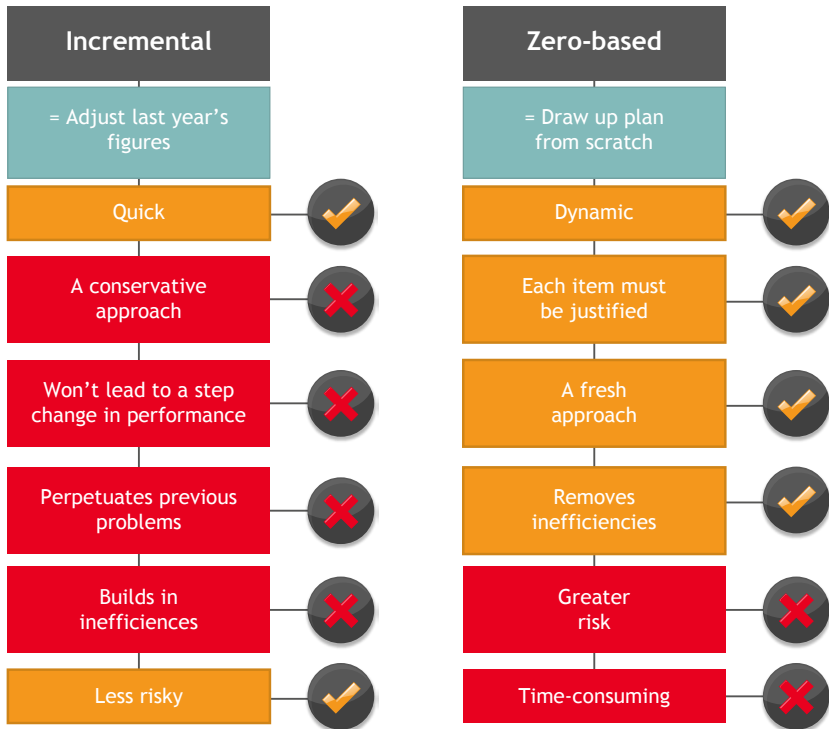
Budgeting is central to how an organisation plans to meet its objectives.



The two main ways in which a budget can be drawn up are:

Incremental budgeting, in which last year's planned income and expenditure are adjusted to actual performance and other foreseeable changes, such as inflation.

Zero-based budgeting, in which the plan is drawn up from scratch, without reference to previous figures.



Incremental budgeting is much quicker, but more conservative. It assumes continuity, and probably won't lead to a step-change that significantly improves performance. Instead, it perpetuates previous problems and builds in inefficiencies. However, it is less risky because it involves less change.

Zero-based budgeting is more dynamic, since it requires each item to be newly justified. It therefore encourages a fresh approach that removes inefficiencies. It is also more risky, and more time-consuming.

To draw up its sales budget, a business will set targets for the sales volume or

number of units of each product it will sell over the next year, and will state the budgeted or target prices for these sales.

Multiplying these two gives the budgeted sales revenue for each product. The total over several products gives an overall budgeted sales target.

For example, planning to sell 1m apples at 30 pence would give a sales target of £300 000 for apples.

A target sales volume of 2m bananas at 20 pence would give a sales target of £400,000 for bananas.

The total budgeted sales is therefore £300,000 plus £400,000, which equals £700,000.



Budgeted sales of apples = 1,000,000 x 0.30 = £300,000

Budgeted sales of bananas = 2,000,000 x 0.20 = £400,000

Total budgeted sales = 300,000 + 400,000 = £700,000

How do I analyse the sales variance to improve my organisation's performance?

A variance is the difference between a budgeted figure and actual figure – the difference between the plan and reality.

The sales variance is therefore actual sales minus budgeted sales.

At the end of the year, or monthly, managers can conduct a variance analysis to monitor if their targets have been met, and if not, why not.

Variance analysis monitors whether targets have been met, and explains why they have not been met.

If budgeted sales were £700,000 and the business made actual sales of £800,000, there would be a favourable sales variance (F) of £100,000, because the actual result is better than the target.

Where the result is worse than budgeted, the variance is adverse: (A).



$$= 800,000 - 700,000 = 100,000 (F)$$

Favourable variance (F) – the actual result is better than the target

Adverse variance (A) – the actual result is worse than budget

If sales are above target, a good manager would want to know why, in order to replicate it and maintain this high performance.

They would then calculate the sales volume variance. This is the actual sales volume minus the budgeted sales volume, multiplied by the budgeted price.

Using the above example, let's assume that the business sold its apples as planned. Therefore, the variance lies in banana sales volume, so we need only analyse this.

If only 1m bananas were sold instead of the 2m in the budget, the sales volume variance is 1m minus 2m. Multiplied by 20 pence (the unit price), this equals £200,000 (negative). This is an adverse sales volume variance of £200,000 because fewer bananas were sold than planned.

$$\begin{aligned}
 & \text{Sales Volume Variance} = (\text{Actual Sales Volume} - \text{Budgeted Sales Volume}) \times \text{Budgeted Price} \\
 & = (1,000,000 - 2,000,000) \times 0.20 = -£200,000
 \end{aligned}$$

So, why is the total sales variance favourable?

The sales price variance is the actual price minus the budgeted price, multiplied by the actual sales volume.

If the bananas were, in fact, sold for 50 pence (instead of 20p, as budgeted), this gives 50 pence minus 20 pence, multiplied by 1m.

This equals the favourable sales price variance of £300,000 because the bananas were sold at a higher price than budgeted.

Sales price variance =

$$\text{Sales Price Variance} = (\text{Actual Price} - \text{Budgeted Price}) \times \text{Actual Sales Volume}$$

$$= (0.50 - 0.20) \times 1,000,000 = \text{£}300,000 \text{ (F)}$$

*£300,000 (F) Sales Price Variance –
£200,000 (A) Sales Volume Variance =
£100,000 (F) Sales Variance*

Therefore, the manager can see that sales of bananas achieved £300,000 above budget because they were actually sold at a higher price than planned.

However, they varied adversely by £200,000 below the budget because the sales volume target was not met.

Overall, however, there was a favourable sales variance of £100,000.

The manager might then decide to focus on improving sales volume next year by providing more sales training, or using incentive schemes for sales staff to increase the volume of bananas sold. Alternatively, they may simply have to accept

that they budgeted wrongly. They might change their strategy and adjust next year's budget to target a lower sales volume at a higher price, in the light of this year's results.

