



# Chapter 12

## Budgeting and Labour Variances

## How do I draw up a staffing budget?

A business draws up a staffing budget to determine the cost and number of employees at each pay grade, in each department, required over the next year. This helps to plan recruitment and retention strategies, and to estimate the company's labour costs.

Knowing the scale of the work to do and numbers of staff informs the organisation's target-setting and performance management processes.

The staffing budget sets out how many employees are needed and how much they cost. It informs:

Recruitment and retention strategies

Target setting

Performance management

The business will estimate the budgeted or standard number of employees' working hours over the next year. It will also estimate the budgeted or standard rate of pay for each type of worker.

Multiplying the two gives the budgeted staffing cost for each pay grade within each department.



The costs for staff of different pay grades are added together to provide the staffing budget for each department.

All departments' costs can then be totalled to give the organisation's overall staffing budget.

For example, the production department might budget for:

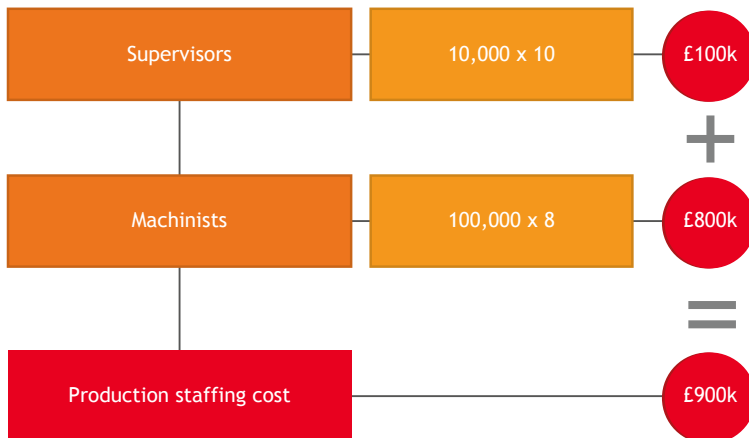
- 10,000 hours of work for supervisors on a standard rate of £10 per hour, totalling £100,000.
- 100,000 hours of work for machinists on a standard rate of £8 per hour, giving £800,000.

The production department's budgeted staffing cost is therefore £100,000 plus £800,000, totalling £900,000.

If, in addition, another department's (say, sales) staffing budget is £600,000, the total staffing budget (for the whole business) would be £900,000 plus £600,000, which equals £1.5m.

$$\text{Total staffing budget} = \text{£900,000} + \text{£600,000} = \text{£1,500,000}$$

#### Production department staffing budget



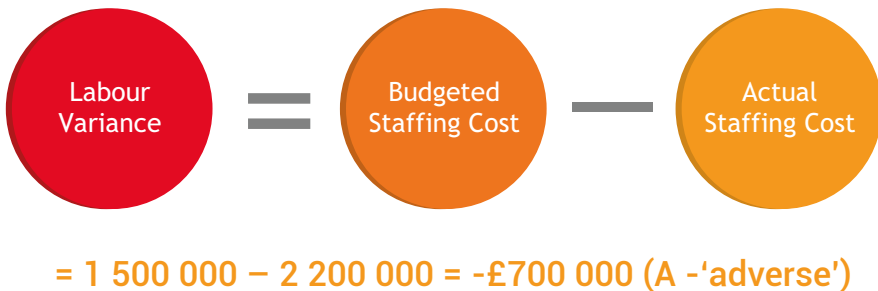
## How do I analyse the labour variance to improve my organisation's performance?

At the end of the year, or more regularly, the finance department will conduct a variance analysis by calculating the labour variance.

*The labour variance is the budgeted staffing cost minus the actual staffing cost*

If the business in our example above had an actual staffing bill of £2.2m, this would be £1.5m minus £2.2m, totalling -£700,000.

The negative demonstrates an adverse labour variance of £700,000, showing that the actual staffing cost is over budget.



Labour Variance = Budgeted Staffing Cost - Actual Staffing Cost

= 1 500 000 - 2 200 000 = -£700 000 (A -'adverse')

To analyse why the staffing is over budget, we calculate the labour efficiency variance. This is the standard number of hours that were budgeted for, minus the actual number of hours worked, multiplied by the standard rate of pay in the budget.

In our example, we will assume that the business employed supervisors as budgeted, so we need only analyse machinists' costs.

If the machinists actually worked 150,000 hours, this means 100,000 hours minus 150,000 hours, multiplied by £8, which equals a negative (adverse) labour efficiency variance of -£400,000, since more labour hours were paid for than planned.

$$\begin{aligned} \text{Labour Efficiency Variance} &= (\text{Standard Hours} - \text{Actual Hours}) \times \text{Standard Rate Of Pay} \\ &= (100,000 - 150,000) \times 8 = -£400,000 \text{ (A -'adverse')} \end{aligned}$$

But this only explains £400,000 out of the £700,000 adverse labour variance. So, we now need to calculate the labour rate variance. This is the standard rate of pay minus the actual rate that was paid, multiplied by the actual number of hours worked.

If machinists were actually paid £10 per hour, this means £8 minus £10, multiplied by 150,000, which equals a negative (adverse) labour rate variance of -£300,000, because labour cost more than planned.

$$\begin{aligned} \text{Labour Rate Variance} &= (\text{Standard Rate} - \text{Actual Rate}) \times \text{Actual Hours} \\ &= (8 - 10) \times 150,000 = -£300,000 \text{ (A)} \end{aligned}$$

Staffing was £700,000 over budget because more staff were employed than planned, costing an extra £400,000. Also, staff were paid a higher than expected rate, costing an extra £300,000. Overall, this matches the adverse total labour variance of £700,000.

**£400,000 (A) labour efficiency variance + £300,000 (A) labour rate variance = -£700,000 (A) labour variance**

### So, what actions should the business take?

It may decide to address the adverse labour efficiency variance by providing better training to raise skills levels, or decide to improve motivation to reduce idle time.

Alternatively, it could address the adverse labour rate variance by reducing overtime and bonus payments, or adopting a tougher negotiating position in wage bargaining.

However, an adverse labour variance does not always mean that the organisation is failing to manage its workforce effectively. The organisation may simply need to correct its budget for the following period, because it underestimated its sales, and consequently needed to recruit more staff than planned.

*Adverse labour efficiency variance – better training to raise skill levels, improve motivation to reduce idle time*

*Adverse labour rate variance – reduce overtime and bonus payments, tougher negotiation in wage bargaining*

*Correct budget*