Why Managers Use Budgets

- To plan and control actions and the related revenues and expenses
- To incorporate management's strategic and operational plans
  - Planning technology upgrades
  - Planning capital asset replacements, improvements, or expansions
- Compare actual results with budgeted amounts to determine corrective actions

Steps Managers Take To Prepare A Budget

- Budget includes three types of budgets:
  - The operating budget
    - Projects sales revenue, cost of goods sold, and operating expenses
  - The capital expenditures budget
    - The plan for purchasing property, plant, equipment, and other long-term assets
  - The financial budget
    - Plans for raising cash and paying debts
- Contain projected amounts, not actual amounts

Variance Analysis

Variance analysis – comparison of budgeted results with actual results

Variance—difference between planned and actual results

- Should be investigated to determine:
  - What caused the variance
  - What should be done to correct that variance

First-Level Variances
(Static Budget Variance)

The first-level variance is the difference between the actual and the static (or master) budget

- Favorable (F) variances
- Unfavorable (U) variances

Question: Why or how come?

Note: static (or master) budget prepared for only one level of sales volume.

e Statement Performance Report

Static budget variance= Actual (column 1) – Static budget (Column 5)

SMART TOUCH LEARNING, INC.
Income Statement Performance Report
Month Ended June 30, 2014

	1	2 (1) – (3)	3	4 (3) – (5)	5
	Actual Results at Actual Prices*	Flexible Budget Variance	Flexible Budget for Actual Number of Units Sold~	Sales Volume Variance	Static (Master) Budget*
Units (DVDs)	10,000	0	10,000	2,000 F	8,000
Sales revenue	$121,000	$1,000 F	$120,000	$24,000 F	$96,000
Variable expenses	86,000	6,000 U	80,000	16,000 U	64,000
Contribution margin	$ 35,000	$5,000 U	$ 40,000	$ 8,000 F	$32,000
Fixed expenses	19,000	1,000 F	20,000	0	20,000
Operating income	$ 16,000	$4,000 U	$ 20,000	$ 8,000 F	$12,000

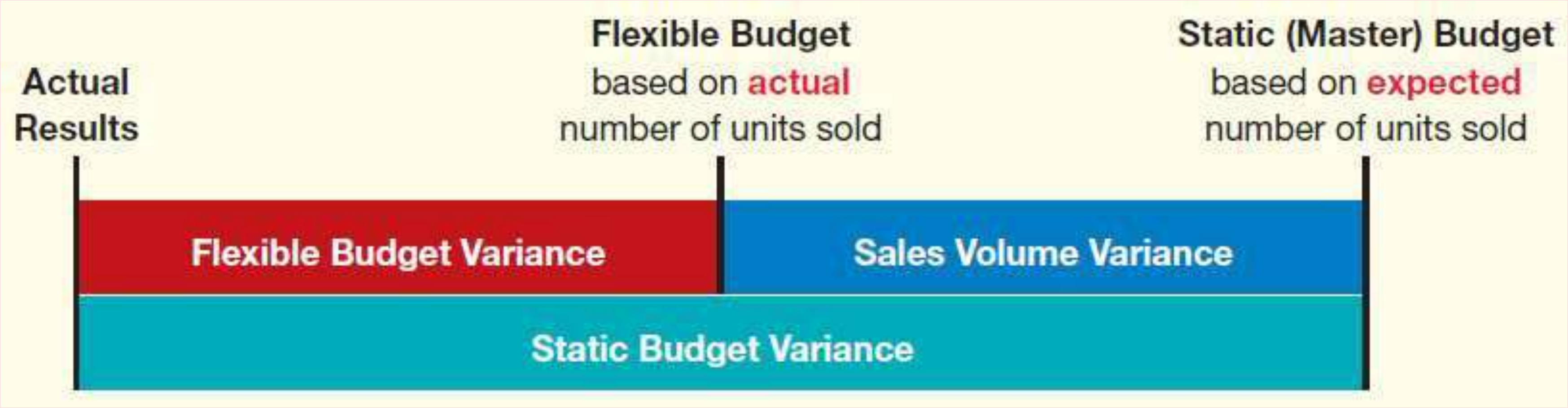
Flexible budget variance, $4,000 U

Sales volume variance, $8,000 F

Static budget variance, $4,000 F

Second-Level Variances

The second-level variances are the sales volume variance and the flexible budget variance



Using the Flexible Budget

Managers divide the static budget variance into two broad categories

- Flexible budget variance
  - Occurs because sales price per unit, variable cost per unit, and/or fixed cost was different than planned
- Sales volume variance
  - Arises because actual number of units sold differs from the amount in the static budget

e Statement Performance Report

SMART TOUCH LEARNING, INC.
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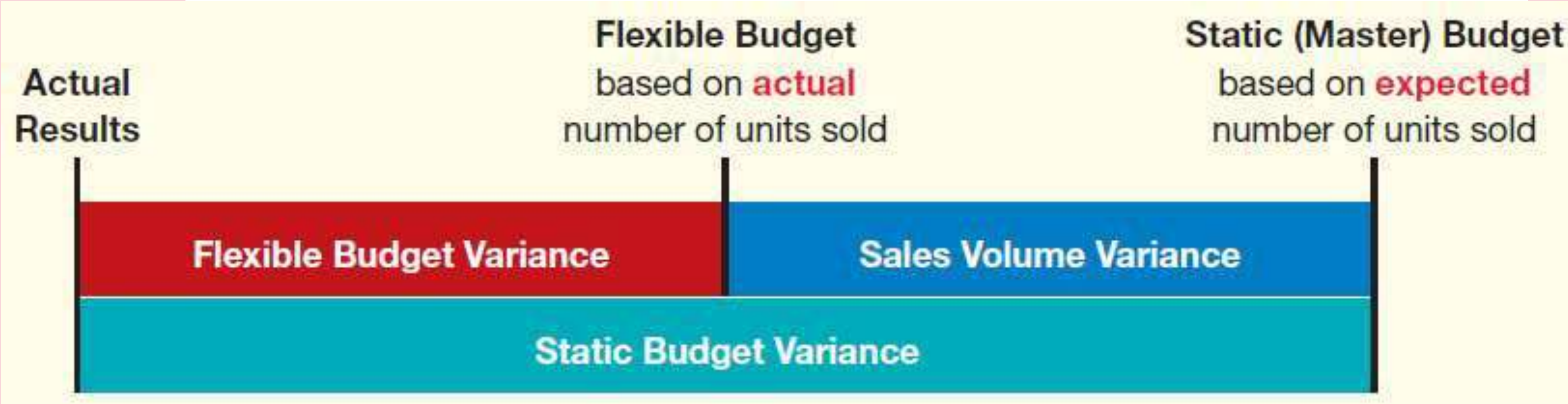
Sales volume variance, $8,000 F

Static budget variance, $4,000 F

Static Budget Variances



Computations

$$\text{Flexible Budget Variance} = \left(\begin{array}{c}\text{Actual Results}\\ \text{for the number of units}\\ \text{actually sold}\\ \text{10,000 DVDs}\end{array}\right) - \left(\begin{array}{c}\text{Flexible Budget}\\ \text{for the number of units}\\ \text{actually sold}\\ \text{10,000 DVDs}\end{array}\right)$$

$$\text{Sales Volume Variance} = \left(\begin{array}{c}\text{Flexible Budget}\\ \text{for the number of units}\\ \text{actually sold}\\ \text{10,000 DVDs}\end{array}\right) - \left(\begin{array}{c}\text{Static (Master) Budget}\\ \text{for the number of units}\\ \text{expected to be sold}\\ \text{8,000 DVDs}\end{array}\right)$$

Done with Second-Level Variance Analysis

Questions on cost – Input price variance or quantity (efficiency) variance?

- Price variance: how well the business keeps unit prices of material and labor inputs within standards.
- Quantity variance: how well the business uses its materials or human resources.