Estimates for the future

When the budget is created it focuses on **estimates** for the future. Over time, it becomes possible to **compare** the **estimates** with the **actual levels** of performance. The aim is to make sure that there is no overspending and the targets are achieved.

Management accounting

Budgeting is a part of **management accounting** and focuses upon the preparation and use of financial plans within an organisation. These plans are a management tool for monitoring and controlling an organisation, or a function / department within an organisation.

Financial tool

For organisations, budgeting can be a very powerful **financial tool**. Maintaining good financial plans can help an organisation to **control its resources**, rather than be controlled by them. Budgets can be used for short, medium or long term planning.

The different types of budget

An organisation can use different types of budgets to help it to achieve its objectives – some common types of budgets are:

- Production
- Sales
- Functional
- Master
- Capital expenditure
- Departmental

See below to see some examples of these different budgets.

Sales Budget

This type of budget shows the total sales expected over a given timescale (often twelve months). The budgeted sales will be shown in terms of their quantities (and / or values) and may be broken down by product or product groups, salesperson, target markets, etc.

Here is an example of a sales budget.

Altitude Peaks Ltd

Extract budget in £ for first and second quarter

Sales 2019	**Q1 Estimate**	**Q1 Actual**	**Q1 Variance**	**Q2 Estimate**
Basic skis				

A production budget will specify the quantities of goods to be produced over a given timescale. It will also specify the costs of direct materials, direct labour and factory overheads for the production of the goods.

Here is an example of a production budget.

Theatre of Fabrics Ltd

Simplified extract budget in £ for first and second quarter

Production 2019	**Q1 Estimate**	**Q1 Actual**	**Q1 Variance**	**Q2 Estimate**
Materials				
Volume	2700			3000
Price	120			1200
Total material value	324000			360000
Labour				
Volume	2700			3000
Price	45			45
Total labour value	121500			135000
Overheads				
Depreciation	10000			10000

This method is based on the previous year's actual figures, adjusted up or down by a percentage or specific amount. The adjustment will be determined by any significant influencing factors identified by the organisation, such as changes in staffing levels, replacing equipment and the increased cost of gas and electricity prices. In some organisations, the adjustment may be as simple as adding the inflation figure.

Priority incremental budgeting

A priority incremental budget has the scope for greater responsiveness to external changes and the requirements of organisational objectives. Here, much more consideration is given to the organisation's stated priorities. The priorities will be carefully considered and the budget estimations will take into account the changes necessary to deliver the priorities. In the areas where there are priorities, budget managers are encouraged to gather information and estimate carefully what needs to be in that section of the budget.

Zero based budgeting (ZBB)

This method of estimation does not depend on past budgets as it starts from zero. Managers are expected to justify their figures in detail.

When using this method, the manager prepares a core bid for the delivery of a specified minimum level of service. Every line and cost must be justified. If 'added value' components are proposed by the manager, they must provide a separate detailed bid with a supporting rationale.

Evidently, this approach requires a significant input of time and resources when compared with the incremental alternative. This may dissuade organisations from using zero based budgeting.

Activity based budgeting (ABB)

When activity based budgeting is used, the planned business activities are specified and then the activities are costed.

Comparatively few organisations apply companywide activity based costing because there is rarely available data to deliver activity based budgeting. However, managers can still apply some of the concepts of activity based budgeting by thinking differently when estimating budgets. Rather than focusing solely on fund allocations, the manager may seek to identify the plans for actual activities and then move to their costings.

When managers identify and cost activities, they may find that there are not enough funds to pay for all the activities. If this happens, the managers may

- Look for cheaper ways of doing these activities
- Only do activities with the highest priorities
- Seek out funds / make a case for them.

Case study - Bargainshop

Jorge, Fiona and Adam all work for Bargainshop, a successful low-cost variety store chain. Read the following below to see how different approaches to making estimates may apply.

Jorge

The collected financial information for the first quarter can be compared with the estimated figures. The updated budget shows where sales are higher and lower than expected. This information can then be analysed and inform subsequent decisions.

Controlling budgets and Revisions

On this page you will learn about:

- Controlling budgets
- Revisions to the budget

Controlling budgets

Once the budgets have been monitored and variances identified, the organisation will seek to find the causes.

When variances are large, plentiful and / or have a significant impact on the efficient running of the organisation, the business operation may be potentially ‘out of control’. In this case, estimates could become meaningless.

Managers must take action. See the options below to see some of the most common control actions.

Making adjustments to conform with an agreed budget

Sometimes the budget managers will be able to tweak certain activities to get the budget back on track. This can directly affect the income and expenditure.

Identifying sources of wastage

The removal of waste will always help to improve budgetary performance. Many organisations use processes such as lean management techniques to reduce waste.

Sourcing lower cost suppliers

This may be done by finding alternative suppliers or making new arrangements with the current suppliers. By having better control of costs, the managers will have better control overall.

Identifying new customers or sales

While the sales and marketing staff may have primary responsibility in this area, the whole organisation can try and identify new markets. This can help ensure that variances in budgets are more likely to be positive.

Developing more efficient work practices and decisions

Continuously looking for ways to work more efficiently and make better decisions improves an organisation’s ability to run an efficient operation. This will manifest itself in the results that are seen in the budget, as they will be more likely to be beneficial for the organisation.

Sharing good practice