Unit 17
Flexible Budgeting

ILO1. Variance Analysis
ILO2. Flexible Budgeting

ILO1. Variance Analysis

The variance analysis cycle is made up of six steps, with the last being the repetition of the previous steps.

1) Performance reports are prepared.
2) Variances are identified between actual results and those predetermined by the budget.
3) Questions are asked why such variances occurred, and if the identified differences were greater or smaller than those of the previous period.
4) Noted variances are investigated for their origin.
5) Once agreed upon, corrective action is implemented.
6) The process is repeated for the next period's operations.

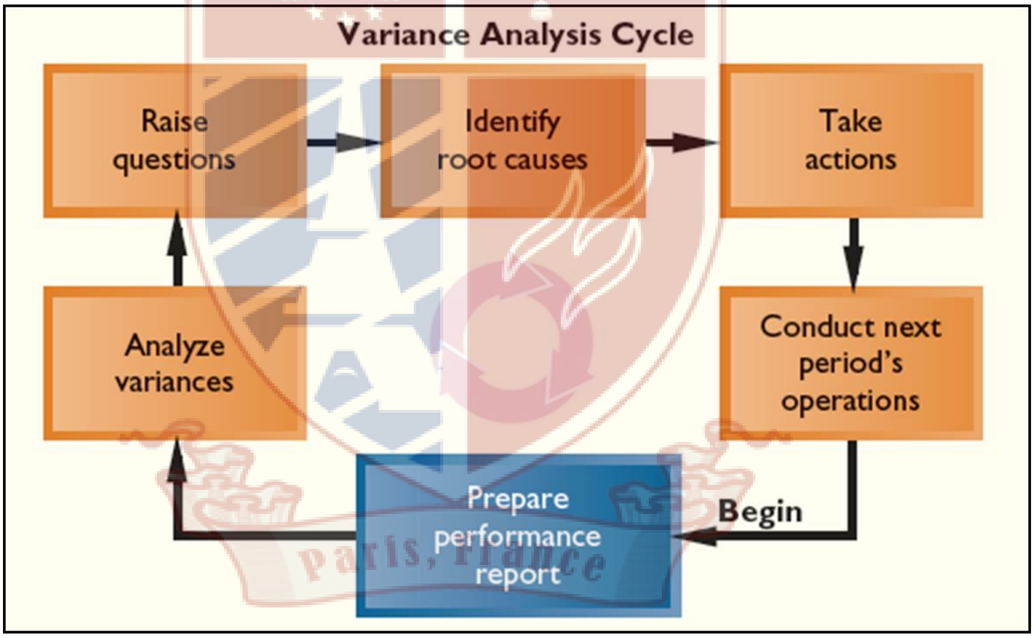

Fig 17.1 Variance Analysis Cycle

ILO2. Flexible Budgeting

To begin our discussion on flexible budgeting we examine the rigid nature of a planning budget. This budget is prepared prior to the operating cycle and is only considered applicable at the planning level of activity. Once operations begin however, the actual level of activity may differ greatly to the planned level, therefore it would not be wise to evaluate operational efficiency by comparing dynamic costs to static costs like those found in a planning budget.

The flexible budget differs as it estimates revenues, and costs based on the perceived level of activity. Other characteristics of flexible budgets include:

- Flexible budgets can be set for any level of activity that falls within its predetermined relevant range.
- Allows for better comparison between costs.
- Helps managers keep control over costs.
- Can be used with other forms of manager performance assessment.

To help illustrate the limitations of the planning budget, we have included the following.

Mary's Drycleaning Service
For the Month Ended June 30

	Revenue/Cost Formulas	Planning Budget
Number of orders (Q)		500
Revenue	($75Q)	$ 37,500
Expenses:		
Wages and salaries	($5,000 + $30Q)	$ 20,000
Supplies	($9Q)	4,500
Equipment maintenance	($3Q)	1,500
Office and shop utilities	($1,000)	1,000
Office and shop rent	($2,000)	2,000
Equipment Depreciation	($2,500)	2,500
Insurance	($1,000)	1,000
Total expenses		32,500
Net operating income		$ 5,000

Fig 17.2 Planned Budget

If we add some variables to this budget it will highlight the limitations found in planning for static costs. Lets assume that Mary's Dry Cleaning is planning for 500 orders. We can see from the budget two variable costs; supplies and equipment maintenance. We can also identify four fixed costs, those being insurance, rent for office and shop, equipment depreciation, and office and shop utilities. And finally, there is one mixed cost which is wages and salaries. If Mary's Dry Cleaning fulfilled 550 orders then we can actually prepare the following report.

Mary's Drycleaning Service
For the Month Ended June 30

	Actual Results
Number of orders	550
Revenue	$ 43,000
Expenses:	
Wages and salaries	$ 23,500
Supplies	5,100
Equipment maintenance	1,300
Office and shop utilities	950
Office and shop rent	2,000
Equipment Depreciation	2,500
Insurance	1,200
Total expenses	36,550
Net operating income	$ 6,450

Fig 17.3 Actual Results

Now to switch our focus by comparing the planned budget alongside the flexible budget. We have the following.

Mary's Drycleaning Service
For the Month Ended June 30

	Revenue/Cost Formulas	Actual Results	Planning Budget	Variances	
Number of orders (Q)		550	500		
Revenue	($75Q)	$ 43,000	$ 37,500	$ 5,500	F
Expenses:					
Wages and salaries	($5,000 + $30Q)	$ 23,500	$ 20,000	$ 3,500	U
Supplies	($9Q)	5,100	4,500	600	U
Equipment maintenance	($3Q)	1,300	1,500	200	F
Office and shop utilities	($1,000)	950	1,000	50	F
Office and shop rent	($2,000)	2,000	2,000	-	
Equipment Depreciation	($2,500)	2,500	2,500	-	
Insurance	($1,000)	1,200	1,000	200	U
Total expenses		36,550	32,500	4,050	U
Net operating income		$ 6,450	$ 5,000	$ 1,450	F

Fig 17.4 Comparative Budget

To analyze these differences, we added a variance for revenue and for expenses. A favourable "F" or unfavourable "U" variance occurs when the actual revenue is found to be greater or lesser than the planned budget. Similarly when the actual expense variance is less than or greater than the planned budget. These makes the manager enquire if the expense variance indicates if the Dry Cleaning store has effectively manager their costs during the period. What the manager can see from these reports, is that the actual variable costs are higher than planned variable costs irrespective of the managers ability. To judge performance of the Dry Cleaning business, we would need to evaluate exactly how much of the cost variances are from increased activity level, and how much are from the managers ability to control costs. To avoid this dilemma we use the flexible budget to allow for the actual activity level.

To fully understand this process, it should be pointed out that variable costs change in direct proportion to changes in activity level. And secondly the static costs (fixed) do not change from the relevant range previously discussed. The flexible budget is below for your study.

Mary's Drycleaning Service
For the Month Ended June 30

	Revenue/Cost Formulas	Flexible Budget
Number of orders (Q)		550
Revenue	($75Q)	$ 41,250
Expenses:		
Wages and salaries	($5,000 + $30Q)	$ 21,500
Supplies	($9Q)	4,950
Equipment maintenance	($3Q)	1,650
Office and shop utilities	($1,000)	1,000
Office and shop rent	($2,000)	2,000
Equipment Depreciation	($2,500)	2,500
Insurance	($1,000)	1,000
Total expenses		34,600
Net operating income		$ 6,650

Fig 17.5 Flexible Budget

In the flexible budget, an activity level of 550 orders is indicated. Furthermore, alongside the revenue and expenses is the variable “Q” this means the cost formula. To apply it to revenue, it would be $75 multiplied by 550, equaling $41,250 and similar for the expense accounts. What you will notice, is that the static costs in the Dry Cleaning flexible budget are immune to variations in the level of activity.

References:

1. Managerial accounting, Ray Garrison-Eric Noreen-Peter Brewer - McGraw-Hill Education, 16 ed., 2018
2. Managerial accounting, John Wild-Ken Shaw - McGraw-Hill Education, 7ed, 2019
3. Management accounting, Will Seal-Carsten Rohde-Ray Garrison-Eric Noreen - McGraw-Hill Education, 6ed. - 2019