

CFO Insider Tools: Flexible Budgets

For many years, I've been a fan of what is known as a Flexible Budget. This is not flexible budgeting in the sense that the government uses – "No money in the budget? Hey, we're flexible. Spend away!"

No, a flexible budget is actually a very useful management tool which brings a new level of clarity to budget-to-actual analysis. In essence, it allows a transparent look at budget-to-actual results for variable costs—generally "direct" costs – by eliminating the sales variance component. A simple illustration should make this clearer (Please see chart below).

If direct costs (Labor, Materials & Freight in this example) are budgeted for on a percentage of sales basis, then we can easily create a Flexible Budget to analyze how well we performed in each class of direct costs.

The flex budget determines "**What should direct costs be for a given level of sales?**"

In our example to the right, we created our budget with an assumption that Materials costs are 50% of Sales. Since we will never hit our budgeted Sales level *exactly*, the variation in actual Sales vs. budget can cloud our assessment of how we did on the direct cost budget. The larger the Sales variation, the more potential there is to reach an inaccurate conclusion. If we look at Materials costs, in the traditional B vs. A report, it looks like an unfavorable variance of (50).

But how much of that is due to the Sales variance, and how much is truly a materials variance?

Using the Flex budget, we 'reset' the direct costs budget to show ACTUAL Sales x the budgeted PERCENTAGE of Sales. Under this method, our Materials budget changes to \$750 instead of the original \$500 – Sales were 50% higher than budget, so we should expect to use 50% more materials. Now we see the true materials variance is actually a Favorable \$200, as opposed to an Unfavorable \$50.

The Materials Manager just went from getting fired to getting a bonus.

The flex budget really brings clarity management's performance on variable costs and eliminates the co-mingling of sales (volume) variances and usage or efficiency variances. Both reports are useful for different types of analysis. And the Flexible Budget can be an important tool in the analysis toolbox.

For more information on using a Flexible Budget in your business, please contact us at info@michiganCFO.com.

	Traditional Budget vs. Actual				Flex Budget vs. Actual				
	Actual		Budget	Variance	Actual	Flex Budget	Variance		
Sales	1,500		1,000	500	1,500	1,500		-	
Labor	450	30.0%	200	20.0%	450	30.0%	300	20.0%	(150)
Material	550	36.7%	500	50.0%	550	36.7%	750	50.0%	200
Freight	100	6.7%	25	2.5%	100	6.7%	38	2.5%	(63)
Direct Costs	1,100	73.3%	725	72.5%	1,100	73.3%	1,088	72.5%	(13)
Contribution	400	26.7%	275	27.5%	400	26.7%	413	27.5%	(13)