**Flexible Budget**

**Flexible Budget Overview**

A flexible budget calculates different expenditure levels for variable costs, depending upon changes in actual revenue. The result is a budget that varies, depending on the activity levels experienced. You input the actual revenues or other activity measures into the flexible budget once an accounting period has been completed, and it generates a budget that is specific to the inputs.

The budget is then compared to actual information for control purposes. The steps needed to construct a flexible budget are:

1. Identify all fixed costs and segregate them in **the budget model**.
2. Determine the extent to which all variable costs change as activity measures change.
3. Create the budget model, where fixed costs are “hard coded” into the model, and variable costs are stated as a percentage of the relevant activity measures or as a cost per unit of activity measure.
4. Enter actual activity measures into the model after an accounting period has been completed. This updates the variable costs in the flexible budget.
5. Enter the resulting flexible budget for the completed period into the accounting system for comparison to actual expenses.

This approach varies from the more common [static budget](http://www.accountingtools.com/questions-and-answers/what-is-a-static-budget.html), which contains nothing but fixed amounts that do not vary with actual revenue levels. Budget versus actual reports under a flexible budget tend to yield variances that are much more relevant than those generated under a static budget, since both **the budgeted and actual expenses are based on the same activity measure.** This means that the **variances will likely be smaller** than under a static budget, and will also be **highly actionable.**

You can create a flexible budget that ranges in level of sophistication. Here are several variations on the concept:

* *Basic flexible budget*. At its simplest, the flexible budget alters those expenses that vary directly with revenues. There is typically a percentage built into the model that is multiplied by actual revenues to arrive at what expenses should be at a stated revenue level. In the case of the cost of goods sold, a cost per unit may be used, rather than a percentage of sales.
* *Intermediate flexible budget*. Some expenditures vary with other activity measures than revenue. For example, telephone expenses may vary with changes in headcount. If so, you can integrate these other activity measures into the flexible budget model.
* *Advanced flexible budget*. Expenditures may only vary within certain ranges of revenue or other activities; outside of those ranges, a different proportion of expenditures may apply. A sophisticated flexible budget will change the proportions for these expenditures if the measurements they are based on exceed their target ranges.

In short, a flexible budget gives a company **a tool for comparing actual to budgeted performance at many levels of activity.**

**Advantages of Flexible Budgeting**

The flexible budget is an appealing concept. We note three particular advantages in this section.

* *Usage in variable cost environment*. The flexible budget is especially useful in businesses where costs are closely aligned with the level of business activity, such as a retail environment where overhead can be segregated and treated as a fixed cost, while the cost of merchandise is directly linked to revenues.
* *Performance measurement*. Since the flexible budget restructures itself based on activity levels, it is a good tool for evaluating the performance of managers - the budget should closely align to expectations at any number of activity levels. It is also a useful planning tool for managers, who can use it to model the likely financial results at a variety of different activity levels.
* *Budgeting efficiency*. Flexible budgeting can be used to more easily update a budget for which revenue or other activity figures have not yet been finalized. Under this approach, managers give their approval for all fixed expenses, as well as variable expenses as a proportion of revenues or other activity measures. Then the budgeting staff completes the remainder of the budget, which flows through the formulas in the flexible budget and automatically alters expenditure levels. This approach can improve the efficiency of the budget formulation process, especially when the management team is working its way through a large number of iterations.

These points make the flexible budget an appealing model for the advanced budget user. However, before deciding to switch to the flexible budget, consider the following countervailing issues.

**Disadvantages of Flexible Budgeting**

The flexible budget at first appears to be an excellent way to resolve many of the difficulties inherent in a static budget. However, there are also a number of serious issues with it, which we address in the following points:

* *Formulation*. Though the flex budget is a good tool, it can be **difficult to formulate and administer.** One problem with its formulation is that many costs are not fully variable, instead having a fixed cost component that must be calculated and included in the budget formula. Also, a **great deal of time can be spent developing cost formulas**, which is more time than the typical budgeting staff has available in the midst of the budget process. Consequently, the flexible budget tends to include only a small number of variable cost formulas.
* ***Closing delay***. You cannot pre-load a flexible budget into the accounting software for comparison to the financial statements. Instead, you must wait until a financial reporting period has been completed, then input revenue and other activity measures into the budget model, extract the results from the model, and load them into the accounting software. Only then can you issue financial statements that contain budget versus actual information, with variances between the two. These extra steps will delay the issuance of financial statements.
* ***Revenue comparison***. In a flexible budget, there is no comparison of budgeted to actual revenues, since the two numbers are the same. The model is designed to match actual expenses to expected expenses, not to compare revenue levels. There is no way to highlight whether actual revenues are above or below expectations.
* Some companies have so few variable costs of any kind that there is little point in constructing a flexible budget. Instead, they have a massive amount of fixed overhead that does not vary in response to any type of activity. For example, consider a web store that downloads software to its customers; a certain amount of expenditure is required to maintain the store, and there is essentially no cost of goods sold, other than credit card fees. In this situation, there is no point in constructing a flexible budget, since it will not vary from a static budget.

In short, a flexible budget requires extra time to construct, delays the issuance of financial statements, does not measure revenue variances, and may not be applicable under certain budget models. These are serious issues that tend to restrict its usage.