Performance Evaluation

Now that we see how to prepare the budget, we must learn how to assess the information that we have just obtained. Budgets are only projections. Certainly we can expect that the actual amounts will have some variations to the budgeted ones. While comparing actual to budgeted, there will be differences. These are called variances and can be *favorable and unfavorable*. An easy way to see the difference between the two is that a favorable variance will have a positive effect on net income. An unfavorable variance, usually denoted by a U has the opposite effect of revenue. It will cause a decrease in revenue either by directly receiving less revenue or incurring higher than expected costs. Managers need to know how much of these variances are caused by poor performance and how much is due to bad budgeting. Remember that small variances may not require much attention. At my company, we do not spend much time on variances that are less than 1% or $1,000.00.

When obtaining pricing and costs for the budget, the company can use various methods or a combination of a few. One way is to observe data from the previous period. That is usually some indication of future performance. Please note that there are many reasons that we must "massage" these figures since no two years are ever identical. Another method is to obtain data from our competitors. Lastly, we can use standard costs that are largely available for most industries and processes.

A new term**, Management by Exception** is introduced here. This is the concept that management must focus on processes that are not performing as expected. After all, if one department or process is operating within budget and successfully meeting all criteria, talent should be focusing on those areas that are weaker and need attention. Just as the budget is one yardstick to measure management's performance, so is **Return on Investment** (ROI). We will look at the ROI for various investment centers of the company, comparing the return that is earned with prior periods and competitor's successes.

ROI = Operating Income/Operating Assets

With everything else being equal, the higher the ROI the better the performance. ROI can also be split into two separate components, one focusing on margin and the other on turnover. There are many other even more complex methods of analysis which take into account the time value of money (**present values**). We will learn about those next week.

Video Alert

I found really good videos for you on Youtube. This introduces us to ROI. The real-life examples of benefits and assumptions in using ROI are very valuable.

http://www.youtube.com/watch?v=8DmChanpSmw&feature=fvsr

http://www.youtube.com/watch?v=IjvfFLTrL8g&feature=related

http://www.youtube.com/watch?v=qYg0FjG5xng

** Web Site Alert**

Click here for great info on ratios!

http://member.accountingcoach.com/explanations/PDF/FinancialRatios.pdf

That's all. See you next time!

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Reference

Edmonds, T. Olds, P., McNair, F., & Tsay, B. (2012). *Survey of Accounting* (3rd ed.). New York, NY: McGraw-Hill Irwin.