

IN THIS ISSUE:
F2 Advanced
Financial Reporting



P1 Management Accounting (also relevant to C02/BA3)

Variance analysis is a popular financial management method that can provide information to help a business operate more effectively and efficiently. To use it well, you need a sound understanding of how your organisation works – and of the caveats that apply to the technique

By Grahame Steven FCMA, CGMA

Variance analysis, which a CIMA survey found to be the fourth most widely used management accounting tool in 2010, is a mechanism for improving an organisation’s performance. The method can be divided into the following three simple steps: work out the variance, determine its cause and take appropriate action.

Variances can be adverse or favourable. Faced with an adverse variance, the manager responsible for it will try to take corrective action. For instance, if the cost of

a company’s raw materials turn out to be greater than it had anticipated, its procurement manager will seek out a cheaper supplier. Cost is not the only issue, of course. Other factors – for instance, the quality of the materials and the supplier’s ability to deliver these on time – will need to be considered by the procurement team in its search for a lower-cost alternative.

People have a natural tendency to focus on what has gone wrong. While it’s essential to do this, it’s just as important to examine favourable variances and find out why improvements have occurred, so as to maintain that level of good performance or make further gains. When a company performs similar activities at different sites, “good news” arising from one location should be communicated to other locations to help them raise their game.

Favourable variances are not necessarily a good thing. While spending less than the budgeted amount on a given process will give rise to a favourable variance, for instance, there may be adverse consequences. Underspending on, say, plant maintenance may cause the firm’s machinery to perform less efficiently, thereby reducing productivity.

Some variances will occur for reasons outside a company’s control. A good example of this is commodity prices. Commodities are traded globally, so companies have little influence on their suppliers. If there is a significant change in price, the budget or standard cost will need to be amended to take account of the new reality.

Another issue to consider when examining variances is the level of difficulty involved. If a standard cost is set at an easy level, favourable variances will generally be reported. If it’s set at a difficult level, adverse variances will generally be reported. Neither situation is desirable, so standards are generally set at a level that can be achieved with some effort. But what one person considers achievable may be deemed impossible by another. It is also important to

recognise that people are motivated in different ways. Some prefer challenging goals; others prefer softer targets.

Many variances can be calculated, even in smaller organisations. It would be unfeasible to investigate all of them, so it’s worth looking into only the most significant ones. But where should you draw the line? The danger with focusing only on variances of more than, say, 5 per cent is that situations that are gradually worsening but don’t meet this criterion will not be investigated. This means that action will not be taken until an emerging issue has become a real problem. Fortunately, by looking at trends to identify situations that are deteriorating (or improving), it is possible to act more quickly. Traditionally, this hasn’t been easy, but advances in IT have transformed variance analysis.

There is another vital ingredient: experience. Management accountants must truly understand their company’s business to provide appropriate support. Management accounting is about the real world – it’s not some abstract exercise performed by people in ivory towers. Most companies comprise many interacting parts. Decisions made in one area of the organisation can affect other areas. For instance, if the procurement team chooses to purchase raw materials from a lower-cost supplier, its decision will have an adverse impact on the factory if these items are inferior to those provided by the existing supplier. It would not be right to congratulate procurement for achieving a favourable variance this way and then castigate the production team for recording adverse variances as a consequence of that purchasing choice. The favourable and adverse variances that result from changing supplier must be considered in combination. If the initial favourable variance does not outweigh the resulting adverse variances, it would be better to return to the original supplier.

The panels on the two next pages suggest possible reasons for a range of standard cost variances.

Panel continues on next page.

Standard cost variances and possible reasons

Sales volume favourable: price reductions increased demand for the firm’s products; it ran a successful marketing campaign; economic growth exceeded expectations.

Sales volume adverse: price increases reduced demand for the firm’s products; a competitor launched a new product; economic growth fell short of expectations.

Sales price favourable: demand for the firm’s products exceeded expectations; a rival company increased its prices; inflation exceeded expectations.

Sales price adverse: the firm reduced prices in an effort to increase sales; its rivals reduced their prices; inflation fell short of expectations.

Material price favourable: the firm negotiated a price reduction with a supplier; it purchased inferior raw materials; its functional currency strengthened (imports).

Material price adverse: a supplier raised its prices; the firm purchased superior raw materials; its functional currency weakened (imports).

Material usage favourable: the firm used superior raw materials; its adoption of new machinery proved successful; changes to working practices improved efficiency.

Material usage adverse: the firm used inferior materials; wastage exceeded expectations and yield declined owing to underspending on plant maintenance.

Labour rate favourable: unemployment increased; the firm employed low-skilled staff; its trade union negotiated a lower pay increase than the firm had expected.

Labour rate adverse: a shortage of skilled workers forced the firm to use agency staff; its trade union negotiated a higher pay increase than the firm had expected.

Labour efficiency favourable: the firm employed highly skilled staff and purchased high-quality raw materials; it spent an appropriate amount on plant maintenance.

Labour efficiency adverse: the firm used low-quality raw materials and underspent on plant maintenance; poor management practices demotivated its workers.

Variable overhead expenditure favourable: costs fell short of expectations; the arrival of a new supplier on the market led to a surplus of supply.

Variable overhead expenditure adverse: costs exceeded expectations; the merger of two suppliers led to a supply shortage.

Standard cost variances and possible reasons (continued from previous page)

Variable overhead efficiency favourable: the firm upgraded its machinery; it improved the efficiency of its working practices.

Variable overhead efficiency adverse: the firm continued to use old machinery; it underspent on maintenance.

Fixed overhead expenditure favourable: a rent increase fell short of expectations; the firm’s stock holding fell short of expectations; batch sizes exceeded expectations.

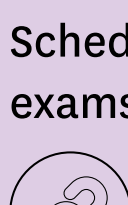
Fixed overhead expenditure adverse: batch sizes fell short of expectations; new health and safety rules took effect; an insurance premium hike exceeded expectations.

Fixed overhead volume favourable: production exceeded expectations, representing an over-recovery of overheads.

Fixed overhead volume adverse: production fell short of expectations, representing an under-recovery of overheads.

Grahame Steven is a teaching fellow and lecturer in accounting at Edinburgh Napier University

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Standard costs are an important benchmark for evaluating performance, but a company needs to use external comparators – eg, direct competitors and/or firms performing similar processes in different industries – to gain a rounded view of its performance.

You can use other companies’ annual reports when benchmarking your firm’s performance, but it can be hard to obtain a large amount of reliable information this way, especially because many companies operate in more than one industry. Trade associations are a good source of intelligence, because they tend to collect large amounts of material, including non-financial information, from their member firms and make it available on an anonymous basis. One of the first entrepreneurs to use such information to advance his commercial interests was Andrew Carnegie, the Scottish industrialist who built a substantial steel business in the US in the late 19th century. His example remains well worth following.