Variance Analysis

Variance analysis compares what was planned with what actually happened, and then explains the difference. Budgets and standards set the plan, and the gap between plan and actual is called a variance. A variance is favourable when it improves profit and adverse when it reduces profit. This video follows one small workshop through price, volume and efficiency variances.

1. Budget Versus Actual

The starting point is a budget: a plan with numbers for sales, costs and profit. After the month ends, actual results are compared with the budget, and each difference is a variance: favourable if it helps profit, adverse if it hurts. A variance is a signal to ask why, not a verdict on anyone's work.

Example: A family plans to spend 400 dollars on food this month and spends 460. With budget versus actual, the gap of 60 dollars is an adverse variance. The family asks why before deciding what to change.

At work: Tariq, the finance manager of a table workshop, budgets 20,000 dollars of sales for the month: 100 tables at 200 dollars. Actual sales are 17,100 dollars, so budget versus actual shows an adverse variance of 2,900 dollars. Tariq now looks for the causes.

2. Price Variance

A price variance shows the effect of a different price. For sales, it is the actual price minus the budgeted price, multiplied by the actual quantity sold. A lower selling price is adverse, while a lower purchase price is favourable.

Example: A shop budgets to sell shirts at 20 dollars but gives a discount and sells them at 18. With price variance, the shop multiplies the 2 dollar gap by the number of shirts sold. The discount shows up as an adverse variance.

At work: Tariq checks price first. Tables sold for 190 dollars each instead of 200, and 90 tables were sold. With price variance, 10 dollars times 90 tables gives an adverse variance of 900 dollars.

3. Volume Variance

A volume variance shows the effect of selling or producing a different quantity. For sales, it is the difference between actual and budgeted quantity, multiplied by the budgeted price or margin. Separating volume from price shows whether the problem is the number of sales or the price of each sale.

Example: A cafe expects 100 customers a day but gets 80. With volume variance, the 20 missing customers are valued at the expected spend. The gap is adverse.

This document is a property of Asaseeyat Academy - © Copy Right Protected.

At work: Tariq checks volume next. The budget was 100 tables but only 90 were sold. With volume variance, 10 tables times the budgeted price of 200 dollars gives an adverse variance of 2,000 dollars, and with the price variance it explains the whole gap.

4. Efficiency Variance

An efficiency variance shows whether inputs such as materials or labour were used better or worse than the standard. The variance multiplies the extra or saved quantity by the standard price. Using more input than the standard allows is adverse, and using less is favourable.

Example: A baker's standard says one cake needs 200 grams of flour, but waste in the kitchen raises the use to 250. With efficiency variance, the extra 50 grams per cake is priced at the flour's standard cost. The waste becomes a visible adverse variance.

At work: Tariq checks materials. The standard is 4 meters of wood per table, so 90 tables should use 360 meters, but the workshop used 450. With efficiency variance, 90 extra meters at 10 dollars each give an adverse variance of 900 dollars.

5. What to Do About Variances

A variance only has value when someone acts on it. First, we check that the numbers are correct. Second, we find the cause by asking the people who do the work. Third, we decide whether the cause is temporary or lasting, and whether the variance is large enough to matter. Then we correct the cause, or change the budget if the plan was unrealistic.

Example: A doctor sees a high temperature and looks for the cause before prescribing anything. With action on variances, the finance team does the same: it finds the cause before it reacts. The right treatment then follows.

At work: Tariq asks the workshop team about the three variances. He learns that a rush discount lowered the price, two big orders were lost, and a badly set cutting machine wasted wood. He fixes the machine first, and wood use returns to the standard the next month.

Conclusion

In summary, variance analysis compares actual results with the plan and explains each gap. A price variance shows the effect of a different price, and a volume variance shows the effect of a different quantity. An efficiency variance shows whether inputs were used better or worse than the standard. Favourable and adverse labels show the direction, but the cause shows what to do. We use variances to ask questions and act early, never to blame.

Sources

- CIMA (Chartered Institute of Management Accountants): management accounting resources and terminology (variance analysis, favourable and adverse variances) – https://www.cimaglobal.com/
- Wikipedia: Variance (accounting) – https://en.wikipedia.org/wiki/Variance_(accounting)
- Drury, C., Management and Cost Accounting (Cengage), chapters on standard costing and variance analysis.

This document is a property of Asaseeyat Academy - © Copy Right Protected.