The Importance of Variance Analysis for Costs Control in Organizations

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ABSTRACT

This review aimed at examining the importance of variance analysis for cost control in organizations. The study x-rayed the concept of variance analysis, types, sources, objectives and its significance. The study reported that variance analysis has significant influence in evaluating individual performance in organizations, assignment of responsibilities to individuals and assisting management to rely on the principle of management by exception and recommended among others, variances analysis should be based upon scientifically established standards.

Keywords: *Variance analysis, cost control, organizations, management*

INTRODUCTION

Analysis of variances is the most important job in the proper implementation of a standard cost system. Cost variances are just meaningless figures unless adequately analyzed and intelligently interpreted. It is only through the medium of this analytical device that the figures can tell the story of what is happening and point the way to improvement procedures. Here is where the standard cost system leaves the realm of technical accounting and dull debits and credits and enters the atmosphere of interpretive and creative analysis for management guidance. Variance is a term used for the difference between actual cost and standard cost. A favourable variance occurs if actual costs are less than standard cost. Ordinarily, favourable variance is assumed to imply efficient performance. An unfavourable variance arises if actual cost exceeds standard cost. An unfavourable variance is supposed to indicate inefficient performance. However, whether performance is really efficient or inefficient will be known only when variances are analyzed in detail by their causes.

Arora (2006) states that variance analysis is the process of analyzing variances by sub-dividing the total variance in such a way that management can assign responsibility for any off standard performance. According to ICMA London, terminology, variance analysis is the resolution into constituent parts and the explanation of variances. An important aspect of variance analysis is the need to separate controllable from uncontrollable variances. A detailed analysis of controllable variances will help the management to identify the persons responsible for its occurrence so that corrective action can be taken. Idornigie (2005) views variance as the deviations of actual performance from standard performance. They are indicators of sub standard performance or super-standard performance. When the costs of actual activity are higher than the standard cost we have adverse variance. On the contrary, when the actual costs are lower than the standard (expected) cost we have favourable variance. Favourable variances point to efficiency while unfavourable or adverse variances point to inefficiency. According to Pandey (2005), there are two types of variances, namely:

Favourable and Unfavourable Variances: Where the actual cost is less than standard cost, it is known as "favourable" or "credit" variance. On the other hand, where the actual cost is more than standard costs, the difference is referred to as "unfavourable" or "adverse" or "debit" variance. In other words, any variance that has a favourable effect on profit is favourable variance and any variance which has an adverse or unfavourable effect on profit is unfavourable variance. Assuming that standard costs have been correctly set, favourable variance is a reflection of efficiency and unfavourable variance indicates inefficiency.

Controllable and Uncontrollable Variances: If a variance can be regarded as the responsibility of a particular person with the result that his degree of efficiency can be reflected in its size, then it is said to be a controllable variance. For example, excess usage of material is usually, the responsibility of the foreman concerned. However, if the excessive usage is due to material being defective, the responsibility may rest with the Inspection Department for non-detection of the defects. If a variance arises due to certain factors beyond the control of management, it is known as uncontrollable variance. For example, change in the market prices of materials, general increase in the labour rates, increase in the rates of power or insurance premium, etc. are not within the control of the management of the company. Responsibility for uncontrollable variance cannot be assigned to any person or department. The division of variance into controllable and uncontrollable is extremely important. The management should place more emphasis on controllable variance as it is these variances which require investigation and possibly corrective action. The controllable variances, on the other hand, may be ignored. This follows the well known principle of exception whereby those matters which are going right are not given attention and any deviations from efficient performance are investigated.

CAUSES OR SOURCES OF VARIANCES

According to Jhingan (2004), variances will arise from the following sources:

Materials Variances

1. Price Variances

ii Paying higher or lower price than planned.

iii Gaining quantity discounts by buying larger order quantities than planned.

iv Buying higher or lower grade/quality of materials than planned.

v Buying substitute materials whose price is different from the planned.

vi Panic buying

Usage Variance

i Quality of materials

ii Substitute materials

iii Technical efficiency

iv Human efficiency or skill

v Pilferage

vi Difference in yield from that planned.

Labour Variances

1. Rate Variance

i Labour unionism and higher rates.

ii Different grades of labour used.

iii Change in labour remuneration method.

iv Change in method of production which may require different grades of labour input.

Efficiency Variance

i Change in operation method facility used by labour which affects efficiency.

ii Grade of labour used.

iii Workshop organization.

iv Adequacy of supervision.

v Grade of materials used.

vi Working condition.

Outside the specific causes listed above, variances can generally arise from the inappropriate or incorrectly set standards, wrong implementation of standard set as when more or less is input than standard, and mis-measurement of actual results.

OBJECTIVES AND SIGNIFICANCE OF VARIANCE ANALYSIS

Arora (2006) lists three objectives of variance analysis as: performance evaluation, cost control and management by exception. A firm operating a standard cost system calculates variances for each element of cost for which standards have been set. Once variances have been calculated, they are analyzed to determine:

1. Where the variance occur?
2. Which cost elements were involved and by what amount?
3. What were the causes of the variances?
4. Who were responsible for the causes of the variances?

Such an analysis thus brings out the significance of variances in terms of their source, cause and responsibility.

i Variance analysis system helps in evaluating individual performances by highlighting the difference in terms of costs between attained performance and desired performance.

ii Variance analysis helps in assigning responsibilities to individuals. Realistically set standards provide challenge to individuals and motivate them to achieve the performance targets.

iii A variance analysis system, combined with an appropriate reporting mechanism helps management to rely on the principle of management by exception. Suitably prepared variance reports call top management attention only to exceptional variances. Variances ranging between certain limits are disposed off at lower levels of management. The variance reports are also condensed in such a way that management is able to understand its implications through a detailed and time consuming study of a number of facts and figures.

CONCLUDING REMARKS

This review examined the importance of variance analysis for cost control in organizations. The study notes the concept of variance analysis, types, sources, objectives and significance of variance analysis. It observed that variance analysis has significant influence in evaluating individual performance in organizations assignment of responsibilities to individuals and assisting management to rely on the principle of management by exception. Consequently, Variances must be based up scientifically established standards. If the standard of performance is not meaningful, variance can be a meaningful measure of performance. Objective criteria should be the yardstick for measuring inputs and outputs. This implies that costs should be classified and recorded in an unbiased and systematic manner. Variance analysis system should be designed to pinpoint the responsibility centre. Standards should be set and variances should be analyzed for each responsibility centre. The quantity of output should be clearly defined and the quantitative measurement of output should be as accurate as possible.

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