Standard Costing – Variance Causation

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Introduction

Standard Costing is both an important and regularly examined area of study on the Professional 1 syllabus. Students will need to understand the benefits of standard costing and its technical processes and how to use the information the system produces to best effect.

Students must appreciate that the essential output from a standard costing system will be the periodic operating statement which reconciles the budgeted profit(loss)/cost to the actual profit(loss)/cost for the period being reported on. It is critical that all Managerial Finance students should be capable of calculating variances accurately and reconciling budgeted to actual performance. Variance calculations have been the subject of a previous Examiner's article.

Once an accurate operating statement is produced, thereafter, it is important that students can identify the likely causes of the variances reported to help ensure that effective corrective actions can be taken. At Professional 1 level students will be expected to identify the most likely causes of the variances reported given the specific circumstances detailed in the question. In considering the causes of variances reported the following guidance should be followed.

Guidelines for Interpreting Variances

1. All textbooks on standard costing will provide pro-forma explanations as to the causes of variances. For example an adverse direct labour efficiency variance could be caused by the following reasons:

i. new production staff have been employed
ii. a new product is being made and existing production staff have not yet moved up the learning curve in relation to the production thereof
iii. production staff are not being paid the full rate of pay
iv. inferior quality materials are being purchased

Whilst it is important that all students study and understand the potential reasons for each possible variance that can be reported, it is unlikely that all reasons listed in textbooks will apply in all cases. Students will be expected at Professional 1 level not to offer a pro-forma list of potential causes but rather to discern the most likely causes of the variances reported given the circumstances detailed in each question.

2. In examination questions information provided in the narrative is likely to indicate the likely causes of the variances reported. It is expected that students should be able to 'read between the lines' of the narrative provided to suggest the likely causes of variances. For example if a new product is being launched the use of a penetration price is a likely reason for a reported adverse sales price variance. Whilst, similarly in the early life cycle of a product sales volumes anticipated may not be achieved explaining one likely cause of an adverse sales volume variance.

3. Often the variance reported whether it is adverse or favourable will have the same underlying reason, only in reverse effect. For example, a favourable materials price variance might be explained by an inferior quality of material being purchased compared to the quality of material allowed in the standard. Similarly, an adverse materials price variance might be explained by a superior quality of material being purchased compared to the quality of material allowed in the standard.

4. Students should be alert to the potential interdependencies between variances. This may take many forms including:

I. Often, where one variance is adverse and its related variance is favourable there may be a common cause for both variances. For example, an adverse direct labour efficiency variance and a favourable direct labour rate variance may be caused by the company employing a lower grade of worker than expected by standard. By saving on the average rate paid to workers the knock on effect may be that this lower grade of staff are not as efficient as the grade expected by standard.

II. The direct labour efficiency variance and the variable overhead efficiency variance are invariably caused by the same reason i.e. if labour is more efficient than the standard thus saving on both the wage bill and the variable overhead cost and vice versa. Both variances will be always be favourable or adverse, favourable if fewer hours than allowed by standard are actually worked to produce the units and adverse if more hours than standard are actually worked to produce the units.

III. Assuming that in the period reported that sales and production volumes are equal (no movement in stocks of finished goods in the period) the sales volume variance and the fixed overhead volume variance (reported in standard absorption costing only) will be caused by the same reason. Both variances will be favourable if more units than budgeted are actually produced and sold in the period and both will be adverse if fewer units than budgeted are produced and sold in the period.

IV. Variances may have the same cause even though they are not directly related. For example an adverse direct materials usage variance and a favourable direct labour rate variance may be a result of the common cause. It may be that lower rates of pay were paid to staff who had not the skills and/or motivation to handle/use materials with the care and efficiency levels expected by standard.

Conclusion

At Professional 1 level students will be expected to consider the question specific circumstances and demonstrate both insight and technical knowledge to identify the likely causes of the variances they reported. The ability to do so will help ensure that subsequent corrective actions are as effective as possible.