

PLANNING

Usage of Variance Analysis Is, Well, Variable

While it's not debatable that variance analysis is an important FP&A tool, companies differ in how they apply it.

Thomas E. Conine Jr. and Michael B. McDonald IV

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Variance analysis, well-recognized as [a valuable tool](#) for business review and planning, examines deviations in operating margin and other financial metrics relative to a budget or prior time period.

Such analysis breaks down the deviations into various decision-based drivers of profitability (e.g., price, volume, cost, productivity) and serves as a gauge of forecasting accuracy and components of growth.

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What's really interesting, though, is that the survey revealed significant disparity in how companies apply variance analysis.

Most companies are simultaneously concerned with business planning, meeting financial commitments, and growth. Accordingly, they should do what we call a “3-Up Variance Walk,” analyzing the variances between:

1. Prior-year actual results and this year's budget (for planning). This is part of the budgeting process.
2. Current-year budget and current-year actual results (for meeting commitments). This is done at year-end.
3. Prior-year actual and current-year actual (for growth) — also done at year-end.

The happy news is that a full 100% of our survey respondents who use variance analysis use it for #2. Almost as good, more than 80% of them use it for #3.

However, only about 50% of the participants use it for #1. That represents a potentially large missed opportunity on the risk-management front. Prior-year-to-budget variances can help reveal what risks a plan may entail, something that can't be done in backward-looking GAAP income statements.

Here's another missed opportunity: only 42% of the survey respondents break down volume variances into “share” and “true growth.” However, doing so can be crucial for

Further, we found that only 60% of the companies perform cash-flow variance analysis. That's surprising, given today's strong emphasis on free cash conversion (i.e., the percentage of net income that converts to cash; most companies aim for 90-95%).

With respect to the various drivers of profitability, a solid majority of the surveyed companies use it for all of the major ones except productivity. We didn't expect that either, given companies' unending initiatives to improve processes and procedures. Here is the full breakdown:

Volume	94%
Price	87%
Product mix	81%
Cost	81%
Foreign exchange	68%
Productivity	48%

Best Practices for Variance Analysis

Using variance analysis to inform decision-making has the following positive impacts:

Competitive advantage: It promotes consistency in meeting or exceeding plan, demonstrates the strength of organizational capabilities, and establishes trust in the leadership team to perform.

Risk management: It gives finance leaders the insights they need to mitigate controllable and even uncontrollable variances.

Shareholder value: When a company combines good internal controls, an effective internal audit process, a cross-functional environment, and a culture of meeting commitments, it increases the probability that variances will be positive — that commitments will in fact be met or exceeded.

- Know your organization's leading generic and custom indicators, with the understanding that their correlations may vary over time. For example, the relationship between price and volume can change, as happens when prices become less elastic.
- Assemble a diverse cross-functional planning team that understands your value stream. Consider a wide range of outcomes and encourage contrarian opinion while having a process in place for reaching consensus.
- Embrace the "3-Up Walk": analyze planning, meeting commitments and growth variances, both at gross and operating margin levels.
- Back test to catch any systematic biases in your variance buckets.
- Take a risk management perspective to break down your variances by controllable and uncontrollable.
- Segment volume variance into share and growth so you can clearly see your organization's true incremental growth vs. growth spurred by an overall market rise.
- Use cash flow variance more ("If the cash doesn't flow, the answer is no").
- Determine accountability for failure to perform (who has ownership of a negative variance to plan).
- Work to eliminate the behavioral biases built into your forecasts.
- Integrate your data analytics into all aspects of variance analysis.
- Create continuing education opportunities for your team around variance analysis best and worst practices.
- Link all business decisions to strategy (a goal of enterprise risk management) while balancing the short and long terms.
- Uncertainty is acceptable, surprise is not. Early misses might be recoverable, so keep the lines of communication continuously open, and develop a system's profitability mindset with all.

These suggestions are not mutually exclusive or exhaustive, and individual practitioners can certainly contribute their own unique perspective on the topic.

relationships with accountability to many.

In such an environment, organizational clarity around structure and process is essential. Everyone must properly understand their roles and responsibilities and to whom they are responsible.

FP&A's responsibility is to help others in their sphere of influence make sound business decisions with the goal of creating shareholder value. Variance analysis is at the heart of business performance.

More details are available on request from authors.

[Thomas E. Conine, Jr.](#) is a professor of finance at Fairfield University and president of TRI Corporation, which specializes in financial education for executives. [Michael B. McDonald IV](#) is an assistant professor of finance at Fairfield University.

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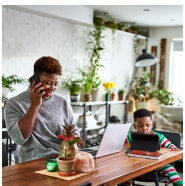
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