

Differences of standard profit and actual profit: case study



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Incognitos latest costume set is Meridas outfit in the Disney Pixar film Brave that sold through internet. The purpose of this report is to analyse and compare the differences of standard profit and actual profit. All calculations are available in the appendices.

1. 1 Absorption Costing System

Absorption costing system is used to cost Merida. It recognizes the importance of absorbing the fixed overhead on valuation of stock in calculating profit as fixed overhead is essential to incur to make product. All fixed and variable production cost is included in stock valuation in absorption costing while, marginal costing only include variable production cost in stock valuation⁵. It allocates portion of fixed manufacturing overhead to each unit of product and hence, it will be brought forward to next period in the closing stock⁵. Also, it avoids fictitious losses being reported. For instance, a company produces more on first few months to cater the sales for the next few months. In absorption costing, fixed production cost will only be expensed off when it is sold. While, marginal costing would expensed it off when it is incurred that may cause a huge losses at the beginning.

The absorption of fixed overhead in stock valuation helps prices to be set with full knowledge of all costs. This is useful for decision making and preparing financial accounts. Additionally, absorption costing system is consistent with external reporting⁵. 2

1. 2 Variance Analysis

Standard costing is predetermined costs that assist in budget preparation and decision-making. It allows profit measurement and inventory valuation

purposes. The variance analysis is applied to explain the deviations in the actual results from budgeted amounts⁸. The results of variance analysis is attributes to different elements such as material, labour, variable overhead and fixed overhead. These would provide a better understanding of the business performance and aware of any changes in the organization, economy, or sector.

The variances might due to several reasons. This variance analysis segregates total variance into different element such as price and efficiency⁸. This sub-decomposition would provide more detail in explaining the deviations.

It helps in performance evaluation that could motivate managers and identify areas of concern that enables managers to focus on the most critical areas⁸. It seeks explanation for variances and helps in planning activity by identifying the necessary early corrective action to be taken depending whether variance is favourable or adverse⁸. It would allow manager to generate more informed future predictions. Therefore, it acts as measurement system and controlling tool to supervise the progress of a project and controlling of future cost by understanding the present costs⁹.

Key findings of the variance analysis

2. 1 Possible reason of variances

The most critical areas are adverse variances especially those with significant figures. The adverse variance of sales margin price might due to overestimation of standard selling price; higher quantity discount given by

sales manager that result to lower actual selling price or bad response of the product that influences management to decide to lower the selling price.

Adverse sales margin volume variance may due to overestimation of budgeted sales that is set without careful analysis of market condition. Also, inefficient sales force such as failure in advertisement (marketing) effort or customer dissatisfaction because of poor quality of costumes. Although the decrease in selling price by \$4 should reflect an increment in sales volume, however, in this case, it is shown as adverse sales volume which might due to economic downturn as what happen to unexpected sales drop of Hennes & Maurit (Fashion retailer) by 5% during Euro zone crisis⁶. The purchasing power of consumer will drop. Hence, despite the drop in selling price, the sales volume will decrease.

Another possible reason for adverse sales price and volume is the escalating market competition in internet of selling children's costume that affects both the sales price and volume to decrease by 4 and 190 units respectively.

Adverse material price variance (Velour fabric and Metal poppers) may due to management careless in purchasing a batch of material with a higher cost without realizing it, ; general increase in price of the material (inflation) or the used of the improved quality of the material. Moreover, it can due to underestimation of material standard price; losing bulk discount as less has been purchased or inefficiency of purchasing manager in price negotiation⁹.

The adverse material usage variances (Satin fabric, Polyester yarn and Velcro) may due to mistake by production department in allocating materials to jobs which causes wastage. Excessive usage may due to excessive
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wastage of materials by untrain workers, faulty machines, poor supervision or theft existence. Furthermore, purchasing department may obtain inferior materials where it may be unsuitable for use and causes excessive waste⁹. Also, it may have stricter quality control where, if any material does not meet certain standards in terms quality would be eliminated².

The adverse labour rate for skilled and unskilled labour may due to inflation or increase pressure by labour union for salary increment. Also, it may be the management strategy to increase worker's morale by increasing the pay so to improve worker efficiency as where it is reflected on favourable efficiency of unskilled labour. There may be also payment of unplanned overtime or bonus where it has to pay more².

The adverse labour efficiency of skilled labour may due to error where the standard time were set too tight without careful analysis of operating condition and the employee skills⁴ or human resource error in employing inexperienced skilled worker and yet still paying high wages of the skilled worker². Moreover, the usage of inferior quality material that leads to inefficiency where more time is needed to produce each costume².

Additionally, this adverse can result by poorly trained or motivated workers which require more time in processing; faulty equipment causing work interruptions; inefficient work schedule and poor supervision of workers².

Adverse variable overhead rate variance may due to underestimation of the rate by management. While adverse variable overhead efficiency variance, may due to adverse figure presented in skilled labour efficiency. The lower productivity causes more time needed for production. The possibility of

factory breakdown causes variable overhead to increase, as a day production is lost.

The adverse fixed overhead variance for supervisor and utilities may due to the general increase in market price due to inflation. This inflation resulted to escalated living expenses and hence, a pay increment for supervisor is necessary. While utilities, the possibility for wastage of electricity and water when machinery faulty or equivalent.

Although the hiring of skilled labour should result to a favourable labour efficiency variance, this adverse variance is possibly due to insufficient demand to keep the workers busy. Hence, production is reduced from 7, 500 to 7380 units due to just-in-time principle. Since workforce is fixed, skilled labour would need to produce less costume, and hence causes inefficient in work as they have more idle time, resulting to the rise of labour hours needed per costume from 1. 25 to 1. 5 hours.

The adverse variance of postage and packaging may due to general increase of international shipping.

Measure should be taken to control the escalating material, labour, variable and fixed overhead rate and decrementing usage efficiency as it would reduce profitability.

It should also understand the reason for favourable variances, so these practices will continue and be used within the organization. Firstly, favourable material price variances (Satin fabric, sequins, polyester yarn, metal hoops and Velcro) may due to inferior quality material usage which

incur lower price, changed to a lower-price supplier, obtaining bulk discount by buying in bulk, industry oversupply of those materials causes the price to drop or material standard price is estimated too low⁴.

The favourable material usage variance (Velour fabric) may due to efficient usage of the material by labour. There may have existence of inter-relationship of material usage and price. The better quality of velour fabric used, the higher the efficiency of the material². Hence, material wastage decreases due to lesser defective material.

The favourable labour efficiency variance for unskilled labour may relate to ergonomics whereby work motivation arises when there is improved quality of equipment or materials, or better techniques of production. Also, it may due to salary increment. Hence, the productivity increases lead to higher efficiency.

The favourable fixed overhead variance (rent) may due to market price for rent have reduced or it shifted to another venue with a cheaper rent.

2. 2 Implication of variances

The adverse variance indicates ineffectiveness and overspending by the business as compared to budgeted figures and vice versa for favourable variances.

Adverse variances would have a negative impact to reconciliation statement that causes lower profit, as more have to pay (Higher expenses) and used (More time and material used). Also, the reputation would be affected as it is

less efficient. Whereas adverse sales price and volume indicates lower selling price and volume sold which causes lower sales revenue.

Favourable variances have a positive effect towards reconciliation statement that causes higher profit as less have to pay (Lower expenditure) and used (Lesser time used).

3. 1 Comparison

Incognito has a net profit margin of 2% as compared to retail clothing sector average of 7.86%. It shows that Incognito has a higher risk that a drop in sales would wipe off profits and cause net losses. This may be due to inefficiency in controlling cost as shown in several adverse variance figures (Material, labour, fixed and variable overhead).

Also, the recession and continuing uncertain economic climate became the greatest threat to sales over the recent years as what happened to H&M with a sudden drop of 5% sales and which is believed has influenced Incognito with a drop of sales from 7,500 to 7,310 costumes.

It is found that the fancy dress industry is competitive as there is shown a growing number of fancy dress like companies and website retail sales exceeded 10 billion in UK alone¹. This would limit Incognito's growth opportunities and reduce its profitability.

3. 2 Recommendation

To improve sales, it is prudent to increase marketing (Advertisement) efforts during slower sales periods as there is more competition and fewer consumers especially during the current Eurozone crisis. It should utilise social

networking features such as Facebook to extend business coverage.

Nonetheless, it should keep up-to-date on the costume trends so it would not be left behind by its competitor.

If the adverse sales are due to quality issues, it may consider using better quality materials or purchasing new machine. New machine would improve quality, productivity (Efficiency) and less maintenance is needed in the long run. Also, it is recommended to develop maintenance schedule to avoid future machine breakdowns that affects efficiency and costume's quality.

To reduce material price, it is recommended to purchase material in bulk which lower the overall material price due to bulk discount given by the supplier. However, it should caution of not causing excessive inventory⁴. Also, it can bargain with the current supplier for a better deal by ascertaining a positive relationship. Nonetheless, it should always monitor the market for other alternative supplier that offers a better deal in term of lower price without compromising the material's quality.

To ease labour rates, it is advisable to hire part-timer rather than full-timer as they are paid according to the actual hours work. This can prevent money being wasted during the idle time and improve labour efficiency. It can consider outsourcing certain jobs to low-cost areas such as Vietnam which is highly productive with lower labour rates. If adverse variance is due to inflation, it is advisable to revise the standard cost regularly so that it will always reflect the current market rates.

For utilities rate reduction, it is recommended to negotiate a deal (Lower utilities rate) with the utilities company or seek for alternative utilities companies that may provide a lower utilities rate.

To strengthen online presence, it needs to continue develop its B2C websites to ensure it is user friendly; high security to build trust and provide sufficient information on products offered³. Nonetheless, interaction with customer and respond to their feedbacks is important³. Also, it should increase its product range of innovative new fancy dress costumes so it would have larger market¹.

Ethical issues are important for sustainability as UK adults claiming to have made purchase decisions for ethical reasons⁷. It should concern with the material used to ensure it is up to certain quality, environmental friendly and cruelty free; employee working condition and pesticide used⁷. Furthermore, issue regarding trademark's copyright. Incognito took design of Merida's costume, a character in the Disney film ' Brave' without the consent of the original designer. This could be subject to copyright issues and can be liable for fine. It is unethical as it is consider stealing of other's trademark.

It should encourage employee personnel development by providing training and improve employee attitudes through motivation. Frequent timely non-financial performance measure is advisable for control purposes such as observing defect rates and number of costumes completed without rework⁴. Additionally, it should identify its market share and target for planning purposes such as expanding and determining quantity to manufacture.

4. 0 Conclusion

Precautionary action should be taken to prevent material price and usage; labour rate; variable and fixed overhead rises uncontrollably in the future which reduces profitability. Nonetheless, non-financial issues such as environmental, working condition and ethics should be taken into consideration.

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