Building a budget is a standard part of doing business for organizations of all sizes and types. But as most financial pros know, making a budget and sticking to it are two very different things. Into every life a few budget variances—differences between actual spend and the amount budgeted—must fall. Human error, changing market conditions, new customers, and even employee fraud can push the actual numbers on your balance sheet a fair distance from their budgeted forebears.

By using budget variance analysis, you can monitor spending to identify where the actual results deviate in your business budget and analyze those deviations to reveal valuable insights. These insights can, in turn, help you improve your financial planning and implement process improvements to hew more closely to your budgets in the future and pursue opportunities to build value.
What is Budget Variance Analysis?

When actual expenses vary from the amounts budgeted, a budget variance is created. These deviations from planned spend are one of several types of variances chief financial officers (CFOs) and other financial professionals analyze to create a clear, comprehensive snapshot of how well their organizations are performing for a given financial reporting period.

These variances are generally split into two broad categories:

1. **Materials, Labor, and Variable Overhead Variances**, which include:
   - **Price/Rate Variances**, or differences between industry standard costs and actual pricing for materials.
   - **Efficiency Variances and Quantity Variances**, or differences between actual input values and the input amounts specified.

2. **Fixed Overhead Variances**, which include:
   - **Volume Variances**, or differences between actual fixed overhead costs applied and budget fixed overhead costs.
   - **Budget Variances**, or differences between actual and budgeted amounts.

For budget variances in particular, variance analysis is helpful in optimizing business budget planning and identifying new opportunities to create value through process optimization, more strategic spending, etc.

Budget variances also contain two subgroups: *expense variances* and *revenue variances*.

As their name implies, expense variances are directly related to costs. They tend to garner the lion’s share of attention during variance analysis because they can be more easily controlled and streamlined than revenue.
Revenue expenses are much more volatile and difficult to quantify or predict. They contain fantastic potential value, however, because analyzing them can help you uncover opportunities to correct or further refine business processes to improve revenue, value, and efficiency while reducing waste and total cost of ownership.

When conducting a budget variance analysis, you have two options: taking corrective action to reduce future variances (this is used in static budgets), or adjust the budgets as required to match actual costs (used with flexible budgets).

> Whether they’re favorable or unfavorable, budget variances need to be monitored and analyzed if you want accurate financial reporting, reliable cash flow, and both short- and long-term planning and spending strategies you can trust.

**Unfavorable Budget Variances and Favorable Budget Variances**

Even though they represent missed spending targets, not all variances are necessarily “bad.”

For both revenue and expense variances:

*Unfavorable budget variances* (also called *negative variances*) are indeed a cause for concern, as they have a negative impact on the company’s profitability, cash flow, competitive strength, etc.

*Favorable budget variances* (also called *positive variances*), however, generally indicate a net gain for the organization, either through actual revenue that’s higher than anticipated or costs below those projected.
Root Causes of Budget Variances

Whether they’re favorable or unfavorable, budget variances need to be monitored and analyzed if you want accurate financial reporting, reliable cash flow, and both short- and long-term planning and spending strategies you can trust. Variances occur for a wide range of reasons; some of the most common include:

- **A shifting market economy**, either due to external factors (disruptions due to natural disasters or pandemics, for example) or internal challenges (underperforming sales and customer support departments).
- **Human error**, which could be caused by a number of factors, including unoptimized budgeting processes, lack of training, etc.
- **Increased competition**, often in tandem with changes to economic conditions and with direct impact on how effectively you attract and retain customers—and important revenue concerns such as sales volume.
- **Supplier pricing changes**, such as a supplier announcing new pricing after your budget has already been finalized.
- **Employee fraud**, a frequent and regrettable source of unfavorable variances.
- **Process Improvement**, which can create more favorable variances through increased efficiency and lower costs.

Benefits of Effective Budget Variance Analysis

Any way you slice it, knowing how your budgeted amounts stack up against actual costs means stronger financial and competitive performance for your organization. In fact, with today’s digital budget analysis tools, you can perform actual variance analysis in real time.
And with a cloud-based budgeting software solution like PLANERGY—supported by artificial intelligence and featuring advanced automation and analysis capabilities—stakeholders from the CFO down get leveled, secure, and mobile-friendly access to the actual numbers in your business budget on demand.

This benefits financial planning and your overall budgeting strategy in several important ways:

- Improved spending decisions based on up-to-date balance sheets.
- More accurate cash flow to help you plan spend to accommodate upcoming expenses or invest strategically while still meeting your obligations.
- Immediate insight into potentially problematic workflows, vendors, or market trends that are affecting spend and creating negative variances and the process and efficiency improvements that support positive variances.
- Accurate and complete financial statements, variance reports, and forecasts, fully customizable for both static and flexible budgets.

**How to Perform Budget Variance Analysis**

While access to digital dashboards, actual variance analysis modules, and other best-in-class budgeting tools help, the basic formula for obtaining the data necessary to a budget variance analysis boils down to two simple formulae:

The first is the positive convention, which measures variance as a positive value (but a negative variance) (negative figures indicate actual figures are under budget, which is a positive variance).

**Actual Spending - Budgeted Spending = Variance**

The second formula is the negative convention, which measures negative
variances as a negative value and positive variances as a positive figure.

**Budgeted Spending - Actual Spending = Variance**

There’s no “right” way here; either convention is acceptable, provided it’s consistently applied across all your analyses.

Of course, obtaining the actual figures for a variance is only the first step. Contextual analysis is crucial to harvesting actionable insights.

So, for example, if your indirect expense account for office supplies indicates a budgeted purchase price of $200 for copier paper, but you spent $600 that quarter, you might be alarmed, since you’re effectively 300% over budget.

However, the overage is only $400 in a budget that might measure in the millions. This is a good point for investigation (is it possible to reduce paper usage by automating certain processes? Can documents be converted to digital versions, eliminating the need for not just paper, but physical document storage and management? Is paper being used for non-company purposes?) and an opportunity to adjust both procedures and future budgets to best meet your business needs, but it’s not a five-alarm financial fire.

Let’s take a look at a more advanced example using a method known as *the column method*.

A leading producer of doodads, Company X ties overhead to production based on direct labor hours. The industry standard is 4,000 hours.

So, Company X’s standard cost card when drawing up their budget might look something like this:

Direct materials cost: 5 pieces/doodad. Unit cost: $0.25

Direct labor cost: 1.5 hours per doodad at $10/hour.
Variable manufacturing overhead: 1.5 hours per doodad at $2.50/hour.

Fixed manufacturing overhead: 1.5 hours per doodad at $3.75/hour

For the month of August, Company X produced 5,000 doodads. The fixed overhead expense budget was $30,000. The actual costs for August were:

Direct materials cost: 30,000 pieces at $0.24 each

Direct labor cost: 4,100 hours were worked (total cost: $41,000)

Actual cost of variable manufacturing overhead: $20,000

Actual cost of fixed manufacturing overhead: $32,000

If we choose to focus on materials variance, we see the following:

\[
\text{Actual Quantity (AQ) of doodads produced x Actual Price (AP)} \, \text{is} \, 30,000 \times 0.24 = 7,200
\]

\[
\text{Actual Quantity (AQ) of doodads produced x Standard Price (SP)} \, \text{is} \, 30,000 \times 0.25 = 7,500
\]

\[
\text{Standard Quantity (AQ) of doodads produced x Standard Price (SP)} \, \text{is} \, 25,000 \times 0.25 = 6,250
\]

This tells us we have a favorable variance on price, since we paid less than standard pricing for the number of pieces used to produce our completed doodads. However, we have an unfavorable quantity variance, as it took 5,000 more pieces than budgeted to produce our completed doodads.

At this point in the analysis, our financial team will likely investigate the reasons for these discrepancies, both to protect (or even positively increase) the price variance while reducing or eliminating the quantity variance, which may be due to quality control issues, supply chain disruptions, or other factors.
Ultimately, ongoing monitoring of those budgets and line items critical to your business can provide you with timely insights you need to either adjust spend to match your budget or reallocate resources to compensate for increased spending needs.

**Stay (or Improve!) the Course with Budget Variance Analysis**

Digging deeply into your spend data and exploring the reasons for variances in your budget can yield rich rewards for the enterprising analyst. When companies understand where their financial health stands compared to their budgets, they can take the corrective actions necessary to recover lost revenue and value—or, better still, leverage the insights they’ve gained to make more strategic business decisions and pursue new opportunities for efficiency, profitability, and competitive advantage.

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