Budgeting for Not-For-Profit Organizations

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Introduction

Budgeting is often viewed as either a scary, time-wasting, or useless activity. Hopefully we can dispel some of these views. In attempting to do so, we are going to look at why budgeting is important and why you should create one. Then we’ll look at some background information on budgeting, the actual budgeting process, and some common pitfalls to avoid. Finally, we’ll talk about how to live with the budget you create.

So let’s get started. What is a budget? In reality, a budget is nothing more than a quantification of the organization’s goals and objectives. At a more detailed level, it can also serve as a road map for reaching those goals and objectives.

Why should you create a budget? A budget serves three primary purposes: It is a planning tool, it is a control tool, and it is a motivating tool. When created and properly used, it serves all three purposes. But one of the reasons that budgets—and budgeting—get a bad rap is that so many people view a budget as a static document. In reality, for a budget to be most effective, it must be a dynamic, living creation. It requires continued review and revision. Situations change, goals and objectives change, and opportunities arise. All of these can result in revisions to a previously created budget. Yet, many organizations are afraid to make perfectly reasonable changes to their budget so it can reflect the new reality.

Budgeting concepts and background

Before we actually talk about creating a budget, let’s get some basic budget-related concepts out of the way. First, we need to address the idea of cash budgeting versus accrual budgeting. Generally speaking,
when you look at a set of audited financial statements, you are looking at numbers prepared using accrual accounting, which means that revenues are recognized when they are earned (not when the cash is actually received) and expenses are recognized when they are incurred (not when the cash is actually paid out). However, for most handbell-related organizations, accrual accounting is of limited value. For these organizations, a cash-based accounting model makes more sense. Under such a model, you record revenues when the cash is received, and you record expenses when the cash is paid out. Even organizations who do use the accrual accounting model often prepare their budgets using the cash accounting model. The remainder of this discussion will focus on a cash-based budget.

Another issue that needs to be addressed is the idea of organizational versus program budgets. Often the budgeting process can include both. Program budgets are prepared for a specific program (perhaps your group has a youth outreach program where you can identify specific sources of revenue and expenses) or event (such as a concert tour). You may want to prepare separate budgets for such programs and events and then monitor actual revenues and expenses against these budgeted figures. These program budgets, however, must eventually be rolled up into the overall organizational budget, which should encompass all of the organization’s activities.

Finally, a budget is not a financial report, per se. It is a management tool—a way to quantify the organization’s goals and objectives and then monitor the actual activities against those plans. This gives us much more flexibility in how we organize and report accounting information. We are not bound by the accounting rules that govern published (or unpublished) financial statements. So, if your group does prepare financial statements in accordance with what are known as “generally accepted accounting principles,” you will most likely see things on those statements that are shown differently than how they may appear on your cash budget.
Starting with revenues, we find that money received comes in one of two flavors: unrestricted and restricted. Restricted revenues have strings attached. For instance, the cash can only be used to offset the cost of your Christmas concert at a specific venue; or the cash must be invested, and the earnings each year can only be used to purchase new music in the following year. Unrestricted revenues, however, have no such strings. It is cash that comes in that you can spend however you want. When you accept a restricted contribution, you have an obligation to use the money as intended by the person making the contribution. In preparing your budget, you must make sure that the donor’s intentions are followed.

Expenses also come in two primary flavors: fixed and variable. Fixed expenses are those expenses that do not change over time, regardless of how many choir members you have, how many concerts you perform, etc. Insurance on your bells might be an example. It doesn’t matter how often you play them or how many ringers you have, the insurance is the same amount. Variable expenses, on the other hand, will vary over time based on some identified driver (unit of activity). For example, music purchases or travel expenses will vary in a way that is proportionate to the number of musicians or music stands. Understanding these relationships will make the budgeting process easier to understand.

Let’s get started

Step 1
So, you need to build a budget. Where do you start? Step 1 should
always be to make sure you understand the group’s mission. What are the group’s expectations? What does the group hope to accomplish? Budgeting should force (and focus) a discussion of the group’s goals and objectives on the front end of the budgeting process. These kinds of decisions are generally better made through a focused, purposeful discussion, not on the fly. This discussion should also include an understanding of what resources will be needed to accomplish the group’s mission. The budget should represent a quantification of these decisions. It also provides a reality check to assure that the ambitions of the organization are realistic and attainable.

**Step 2**

Once the group has made the decisions outlined in Step 1, it is time to begin the data collection work. You need to make a list of each of your organization’s sources of income and types of expenditures. Often, past history can serve as a guide here, but remember that the organization may be embarking on a new activity or program that will have different revenue sources or types of expenditures that were not present in prior years, so you can’t simply look at past years to the exclusion of what you know about the coming year.

Beside each item on the list, you need to write down what you know about that item:

1. Do you know the amount of this revenue or expenditure item? Can you make a reasonable estimate if the exact amount is not known?
2. Is the amount the same every time?
3. Does this item occur regularly, at the same time each month or year?
4. Is this item seasonal (only occurring at certain times)?
5. Is the amount dependent on some other variable or person or event? In other words, is this item fixed or variable in nature?
6. Can you control when you receive or pay this amount?
7. Is this a revenue item that can only be used for a specific purpose?
8. Is this an expense item that must be paid with (or limited to) a specific revenue item?

As you make this list, talking is good. Ask lots of questions. It’s perfectly all right to not know all the answers. What is not acceptable is not finding out the answers. Building a budget based on bogus information serves no useful purpose. The more input, the better. Budgets should be participative. By making this a group exercise, the group “owns” the budget and has a stronger incentive to follow the budget and use it as it should be used.

What happens if this is your group’s first year (or first attempt at building a budget), and you don’t have anything from prior years to serve as a guide? You would start with the group’s mission statement, goals, and objectives. What kinds of activities are envisioned to support that mission statement? Research costs and potential sources of income. If possible, look at budgets from other, similar organizations. Perhaps you can start a forum on the Handbell Musicians of America website where budgeting information can be shared between groups. It is easy to overlook or underestimate expenses. Again, knowledge and information are key. The more we understand and know about our group’s activities and can quantify that understanding into dollars, the more valuable the resulting budget will be.

**Step 3**

The next step is to determine the level of detail you need for the budget. The level of detail for both timing and categories of revenue and expenses must be established. Let’s discussing timing first. Are you going to prepare a simple budget for the entire year (annual budget) or are you going to break it down into quarters or months? Comparing actual results to your budget is easier if shorter budgeting periods are used. However, shorter budgeting periods require more information. A monthly budget is not an annual budget divided by 12. For it to be an
effective tool, you must budget revenues and expenses according to what month you expect them to occur.

Take music purchases as an example. Let’s say that your group prepares its budget on a program year that runs from July through June, and you have budgeted to spend $1,000 on new music for the year. Let’s also assume that most of your music purchases happen in July ($600), August ($200) and January ($200). So your annual budget would show the entire $1,000 for music purchases. A monthly budget, however, would show $200 in January, $600 in July, and $200 in August, with nothing listing for the remaining months.

To demonstrate why budgeting in shorter time frames might be helpful, let’s also assume that it is the end of July, and you have spent $900 on music purchases. If you only prepare an annual budget, and your group has spent $900, you wouldn’t necessarily realize that you have overspent July’s budget and have only $100 left for purchases in August and January. All you would know is that you still have $100 to spend on music. However, if you prepared a monthly or a quarterly budget, this discrepancy would be more obvious.

If cash is tight, and it is necessary to keep a close watch on cash flow, shorter budgeting periods generally make it easier to see what revenues and expenses are expected to occur each month. This, in turn, makes decisions about spending easier and more straightforward. However, even if you do adopt a shorter budgeting period, never lose sight of the group’s long-term goals. As many for-profit and not-for-profit organizations have learned, there is a delicate balance between good short-term decisions and healthy long-term prosperity.

The second level of detail you need to consider is how to categorize the revenues and expenses in your budget. What level of detail do you need? Should you budget in large, general categories, such as “insurance”? Or should you use smaller, more detailed categories like “property insurance,” “liability insurance,” “directors and officers insurance,” etc. The finer the level of detail, the more time will be required
to initially prepare the budget, but the easier the budget will be to use throughout the year. Obviously, the more information your budget provides, the better a tool it will be for planning, controlling and motivating.

**Step 4**

Now it is time to actually begin building the budget. Based on the data you have collected and the decisions you have made about levels of detail, the actual building of the budget should be straightforward. Before we begin, however, you should be aware of a few common pitfalls in budget building:

1. Overestimating revenue amounts and underestimating expenditure amounts
2. Underestimating when revenues will be received and overestimating how long you have to pay expenses
3. Not planning for the worst of contingencies

We tend to see the world through those proverbial rose-colored glasses. For a budget to be useful and successful, it needs to be based on reality. A budget, by definition, is based on estimates. Those estimates, however, need to be as objective as possible.

When actually building the budget, spreadsheet software is quite helpful, but not required. Familiarity with spreadsheets can speed up the process of budget building by eliminating a lot of repetitious math calculations. By doing a thorough job in the earlier steps, this part of the process is really just compiling the information you have already collected.

Some items are easy to budget. An example would be your organization’s Handbell Musicians of America dues. You know the amount and you know when it is due. Most fixed expenses fall into this category.

Some budget items are more difficult to estimate. Bell repair costs might be an example. We all know that bells need maintenance and
repairs. However, bells do not break on a predetermined schedule. Nor do all repairs cost the same. So, in this case, neither the amount nor the timing may be known. All you really know is that it is likely that some amount of cost will be incurred for bell repairs and maintenance. In such cases, you can often look at past experience (adjusted for price increases) to make an estimate of how to budget for such items. Also, keep in mind that if you have your bells on a regular maintenance/refurbishing schedule, you need to be sure to include that in your budget. For example, let’s say that you have your bells refurbished every three years. Each year’s budget should include provisions for saving one-third of the refurbishing costs. Then you will have adequate cash on hand in year three to cover the cost of the refurbishing.

Other budget items fall in between these two groups. Music purchases are an example. While we generally know how many copies we need to order of each new piece of music, we might not necessarily know the exact price or how many new pieces will be ordered. This is an example of how the budgeting process can help clarify the organization’s planning process. Through the budgeting process, your organization can make decisions such as how many new pieces to purchase each year versus how many pieces to use from your existing library. Involving as many people as possible in the budgeting process helps in making informed decisions. This is also information that the artistic director needs while planning repertoire for the year. By making these decisions on the front end, the organization avoids situations where necessary marketing and promotion can’t be done because all the money had previously been spent on purchasing new music.

As you put your budget together, there are really two different approaches you can use. One is to first estimate how much revenue you expect to generate during the year and then use that figure to determine how to allocate expenses. You cannot budget more expenses than the total revenue you expect to generate plus any carryover funds you have from previous years.

The second approach is to estimate the amount of expenses you
expect to incur and then let that drive the amount of revenue you must generate. This gives you an idea of how to set ticket prices of concerts, how much you need to solicit in the form of donations and grants, etc. In actuality, most groups use a combination of both approaches in order to reach a workable budget. Again, be cautioned against being overly optimistic about how much revenue your group can generate or how tightly you can control expenses. Be realistic in your budget assumptions.

While it should be obvious, in most cases a group should not budget to incur more expenses than it expects to generate in revenue. The difference between expected revenues and expected expenses should either be zero or result in more revenues than expenses. The opposite situation (total expenses exceeding total revenues) is really only appropriate when you have a cash surplus that the group has made a conscious decision to reduce. However, remember that once that surplus is gone, your group has to go back to “living within its means,” which you may find difficult to do. A better approach might be to use cash surpluses for one-time purchases (adding a sixth and/or seventh octave of bells or chimes or providing scholarships for young ringers to attend a national seminar) rather than use that surplus for normal operating costs.

Finally, you need to return to the idea of program or event budgets. If you find yourself in a situation where you have programs or events that have their own source of income and associated expenses, then preparing a budget for that event or program might be beneficial. In such cases, it is usually easier to build a budget for each program or event first. Then you can carry the totals from your various program and event budgets forward to your overall organizational budget. In many cases, there may be some organizational expenses that could be considered a cost of the program or event (these are often called “allocated expenses”). In the hard-core budgeting world, there are various methods for allocating such expenses. But to keep things at a simple and manageable level, the easiest solution is to simply ignore such expenses and continue to consider them as being totally organizational expenses.
Budgeting pitfalls

There are a few areas where potential budgeting problems may be lurking. A discussion of budgeting wouldn’t be complete without shining some light on these areas.

**Payroll**

If you have people you are paying, don’t forget about payroll taxes when you are preparing your budget. The combined FICA and Medicare rate is currently 7.65%. These taxes must be paid monthly on the 15th day of the month following when the employee is paid. You may also be subject to unemployment taxes, depending on the state you are in and the number of employees you have. If you are subject to unemployment taxes, be sure to include them in your budgeting process.

**Infrequent Expenditures**

Bell refurbishing and purchases of new equipment were mentioned earlier as infrequent expenditures. Often groups have a planned savings program for such expenditures. Planned savings should be included in your budget just as expenditures would be. It is too easy to spend the money you should be saving on something else if you don’t memorialize it in your budget. Another suggestion would be to put that money in a separate savings account so you don’t see the dollars sitting in your checking account every time you look at your bank statement. There is a huge temptation to use money saved for one purpose for something else. We often rationalize our action with words like, “We still have time to save enough money.” While it is perfectly acceptable for a group to change its plans (just as it is acceptable to adjust a budget), having the savings program built into the budget forces the group to consciously decide to go a different route rather than making an “on-the-fly” decision.
State and Local Laws

Don’t be caught (or even surprised) by state and local laws and regulations. Are sales taxes required to be collected on ticket sales? What about tourism taxes on entertainment? Are there special exemptions for not-for-profit organizations? The standard adage that “ignorance of the law is no excuse” applies here. The budget planning and preparation process is a good time to find out answers to these and other questions.

Not Sharing Budget Information

Everyone who is going to be affected by the budget should be involved in the process of building the budget. Involvement helps ensure ownership of and adherence to the budget. For instance, the equipment manager needs to know just how many dollars are in the budget for equipment needs. The music director and librarian need similar information regarding music purchases. Involving such persons in the budgeting process also helps with coordination and with the transfer of specific information and decisions.

Never Adjusting the Budget

Circumstances change. Perhaps you suddenly find that your group is having to pay rent for rehearsal and storage space, and rent isn’t in your budget. Or perhaps an assumption you made in preparing your budget doesn’t materialize (a major donor decides not to contribute this year, for example). If it is a small change, you can probably find a way to adjust the budget to accommodate a new item or an item with a changed amount. However, a significant change requires that you “rethink” your budget and decide how to reallocate your budgeted resources to deal with the changed situation. Don’t be locked into a budget that does not reflect the reality of the situation.
Living with the budget

Now that your organization has a budget, what do you do with it? First and foremost, you use it to monitor the group’s activities. A budget is a tool to help you know what is happening and why. Compare actual expenses to what was budgeted. Understand why actual numbers vary from the budgeted figures. Such differences are normally referred to as variances. There can be very valid reasons for this, but not understanding those reasons defeats the purpose of budgeting. Ask, ask, ask! Talk to people. Ask questions when you don’t understand why there are variances. Again, this is another example of using the budget to help disseminate information among the various stakeholders in your organization.

A standard budget report often shows the budgeted numbers, the actual numbers, and the amount of the variance. If your budget has been done on a monthly or quarterly basis, then these columns often get expanded so that there are budget, actual, and variance columns for the month and also for year-to-date totals. Remember that, for most budget items, the budget amount and the actual amount will rarely match exactly. Differences of a few dollars are to be expected because of the nature of using assumptions to build the budget. However, significant variances need to be investigated and explained as discussed in the preceding paragraph.

Someone must have the job of “enforcer.” That person must have the authority to say no. This implies that procedures are in place for getting approvals before dollars are spent. If there is no one willing to say no, then the whole exercise of building the budget will appear to many to have been pointless. This will make the budgeting process even more difficult in subsequent years. Without venturing into the realm of psychology, suffice it to say that there are better ways and worse ways to be an enforcer. The way that the enforcer says no goes a long way toward protecting the integrity of the budgeting process.
Finally, the budgeting process can be a great motivator. The group’s leadership should use the budget to encourage meeting the group’s mission. The budget can quickly show the level of fundraising needed to support the level of activity contemplated by the group. Spending must occur for the group to further its mission. The budgeting process can help the group identify what expenditures fall into the nice-to-do category versus what falls into the need-to-do category. The logical consequence of making such decisions should result in some sort of prioritization of expenditures. Again, handled correctly, this can serve as a great motivator to the group.

For many of us, budgets are easy to put off. We think we can stumble along just fine without one. What often happens without a budget is that organizations become dependent on one or two persons to make financial decisions that may or may not be in the best interests of the entire group. Budgets allow groups to come together and make those decisions jointly and to facilitate the sharing of financial knowledge. Group cohesion is enhanced when stakeholders support the group’s mission and feel that the group’s finances are being handled in accordance with that mission. A good budget helps accomplish both.