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Nonprofit Budgeting Part I: Budget Basics

Many of us are initially drawn to work in nonprofits because of a commitment to the causes our organizations work toward. At some point we may find ourselves responsible for helping to develop and manage the financial resources of the organization, with little experience with the tools and language of finance.

This workshop is designed for people who are new to budgeting and want to get a baseline understanding of the components of a nonprofit budget. We will demystify some of the terminology around budgeting, share examples of different types of budgets and when they are useful, and practice reading and interpreting both organizational and program-level budget-to-actual reports.

Learning Objectives

By the end of this workshop you will:

- Increase your understanding of the basic terminology and concepts related to nonprofit budgeting.
- Practice reading different budgets and budget to actual reports and identifying the right format for your organization or program.
- Begin to identify the connection between organizational values and the budget including how power dynamics influence financial decision-making.
- Build a customized step-by-step checklist for your organization or program’s budgeting process.
Nonprofit Budgeting Part I: Budget Basics

The annual budget is the financial reflection of what a nonprofit business expects to accomplish over a 12-month period. For many nonprofit leaders, budgeting is the most comfortable and interesting part of financial leadership. Done effectively, the budgeting process actively engages many staff and board members who may be uninterested in accounting or monthly financial reporting. It becomes an opportunity for these stakeholders to contribute to the organization’s goals and priorities. For most organizations, the annual budgeting cycle also offers the best (if not the only) time to set meaningful financial goals. The process results in a useful tool—one that will be used to anticipate problems and to provide a baseline against which actual program and financial experience can be monitored.

A Tool for Planning and Monitoring

Planning: The process of building a budget is fundamentally a planning process. In fact, in the course of planning for its future, an organization will often regularly revisit its goals, priorities, and activities. This is a healthy and necessary time of annual reflection and one of the primary reasons that the budgeting process should begin several months before year-end. Even in a relatively straightforward budgeting process where there seems little doubt about the organization’s overall direction, the act of determining what the organization wants to accomplish, how much that will cost, and how the necessary resources will be generated is a form of strategic planning—if done thoughtfully.

Monitoring: Once adopted, the budget becomes an essential financial management tool helpful in monitoring ongoing organizational activities throughout the year. With each reporting cycle, the organization compares actual performance against its plan. If the organization has gone “off track,” various responses can be considered. If, for example, a program is costing more than anticipated, it may be necessary for management to bring costs down through staff reductions.
or a freeze on non-personnel expenses. Or leadership may decide to revise the plan to take the higher level of expense into account. Using the budget as an ongoing monitoring tool raises these sorts of strategic discussions at the staff and board levels in an ongoing and timely manner.

**An Inclusive Process**

In order for an organizational budget to be accurate, effective, and uniting, *the budgeting process must be inclusive*. While the executive director and key finance staff often play the coordinating role in the process, all management team and board members have a role to play. Designing an effective process that engages people with multiple perspectives can be challenging. Program planners and fiscal managers often speak different languages and may have different priorities; they may or may not be aware of the importance of each other’s approach to the budget process. Program planning decisions may be viewed as failing to reflect economic realities, while fiscal management decisions are sometimes seen as insensitive to the programmatic mission of the organization. These conflicts are often fought out during the budgeting process—the very process that could unite these viewpoints. The leadership challenge is to highlight and integrate these various perspectives the collective goal of developing a realistic and inspiring plan for the coming year.

To be sure, an inclusive process can be a messy one with a great deal of debate and even frustration at times. The budgeting process is the ideal time each year to bring an organizational cross-section into the financial leadership effort. The executive director that creates the budget during an all-nighter before the first board meeting of the year—or asks her finance manager to do so—is almost guaranteeing a less-than-accurate plan and a useless tool for controlling financial activity throughout the year. People in your organization will feel more accountable to a plan that they had some say in developing. In our consulting work with nonprofits, we do not see leaders having much luck holding program and development staff accountable to budgets they did not contribute to meaningfully.
What’s my role?

A person who fills a particular position in an organization (e.g. executive director, finance manager, program director, etc.) may participate in and influence the organization’s budgeting process in several ways. Clarifying roles and decision making power is critical in an inclusive process. The RACI decision-making model is one way to help clarify people’s contributions.

<table>
<thead>
<tr>
<th>RACI Role</th>
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| **Responsible “the doer”** | a person who does the work of developing the budget  
Examples:  
- finance manager who designs the budget tools and integrates the figures contributed by others into a cohesive whole  
- program manager who determines costs for direct program expenses (costs of site rentals, program-specific supplies, etc.)  
- development manager who develops detailed fundraising plans and proposes a specific revenue target |
| **Accountable “buck stops here”** | a person who is ultimately responsible; holds yes/no decisions  
Examples:  
- finance manager who designs the cost allocation methodology  
- program manager who decides which direct program expenses to prioritize based on increased or decreased revenue projections  
- development manager who determines which foundations will be solicited in the coming year |
| **Consult “in the loop”** | a person who is engaged in decisions; two-way communication  
Examples:  
- finance manager who researches costs for accounting software  
- program manager who is involved in developing a new program partnership  
- development manager who identifies possible donor prospects to pursue |
| **Inform “in the know”** | a person who is informed about decisions; one-way communication  
Examples:  
- finance manager who receives the updated compensation schedule to implement pay increases in the payroll system  
- program manager who receives a budget for direct program expenses (costs of site rentals, program-specific supplies, etc.) to implement and monitor throughout the course of the year  
- development manager who receives a revenue target for annual campaign |
**EXERCISE: What’s My Role?**

Think about the work you currently do or are being asked to do as part of your organization’s budgeting process. What kind of decision-making power do you hold in your responsibilities?

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**Reflection questions:**

1. **What support do I need to effectively embrace these roles?**

2. **Where am I lacking clarity about my decision-making power and what do I need to help clarify my role?**

3. **What work do I want to start or stop doing in relation to our budgeting process and what might be a pathway to support that shift?**
Terminology

**Income:**

**Contributed Support:** Income that the organization obtains in support of its particular cause or mission (such as individual donations, bequests, or foundation grants).

**Earned Revenue:** Income that the organization obtains by providing a good or service in exchange for fees (such as tuition, ticket sales, and some but not all government contracts). This includes sliding-scale fees or those that might only cover partial costs of the services provided in exchange. The services are often, but not always, central to the organization’s mission.

**Net Assets Released from Restriction:** Income that is recognized for use when the donor-designated restriction (time or purpose) has been met. For example, funds that are restricted for a particular program are “released” for use as the costs to run the program are incurred.

**Pass-through Revenue:** Funds provided to the organization that must be spent on behalf of, or passed through to, a secondary agent. Common examples include re-grants or specifically funded program expenses such as site rental or participant stipends.

**Expense:**

**Functional Expenses:** Categorizing organizational expenses based on the activity that incurs them. This way of categorizing costs is driven by the requirements of the Form 990 and by Generally Accepted Accounting Principles (GAAP). Expenses are categorized as either program services (activities that result in goods or services being distributed to beneficiaries, customers, or members in order to fulfill the purpose or mission for which the organization exists) or supporting services (activities other than program services, including management/administrative and fundraising).

**Common Costs (also called shared costs):** Organizational expenses that cannot be attributed to a single function or activity of the organization. Expenses such as rent, general office supplies, or insurance are often categorized as common rather than attributed to a specific program or supporting service.

**Cost Allocation:** The process of proportionally distributing common costs among two or more activities that benefit from those costs. Many organizations allocate common costs based on staff time assigned to each activity, square footage allotted for each activity and/or total direct expenses of each activity. Cost allocation process should be reasonable, documented, and consistently applied.

**Full Program Costs:** While there is no precise definition of this phrase, it typically refers to the total of a program’s direct costs, as well as an allocation of “indirect” costs that may include common costs and supporting costs (administrative and/or fundraising costs). Calculating full
operating costs in this way can help to ensure effective fundraising targets for programs and support effective cost recovery efforts from grants and contracts.

**Fixed Costs:** Expenses that have to be paid by the organization regardless of the revenue generated. These costs do not change when the amount of services increase or decrease. For most organizations, basic operating expenses such as salaries, rent, and insurance fall into this category.

**Variable Costs:** Expenses that increase or decrease depending on the amount of services provided. For example, the cost of workshop personnel and supplies could vary with the number of sessions offered, the cost of meals could vary with the number of participants served, or the cost of filing fees will vary with the number of legal orders filed.

**Other:**

**Change in Net Assets** (*also called net income, surplus or deficit, profit or loss*): Overall financial result of an organization over a period of time (i.e. month, quarter, year). This is calculated as total income minus total expense. When this result is positive (surplus), the organization is building reserves. When negative (deficit), the organization is drawing from reserves.

**Reserves:** Unrestricted cash that is available as a cushion against unexpected events, losses of income or significant unforeseen expenses. Reserves can also be used to fuel program innovation or fund organizational change initiatives. For most nonprofits, reserves are build up over time with small annual operating surpluses. When an organization runs a deficit, it is depleting its reserves. Reserves are reflected on the organization’s Statement of Financial Position (balance sheet) as Unrestricted Net Assets.

**Support Document** (*also called supporting data or support schedule*): Written information attached to the budget that provides backup detail and depth to support particular line-item figures. Common examples include: salary schedules, fundraising plans, enrollment projections, restricted funds release schedule, depreciation schedule, etc.
7 Stage Budgeting Process

I. Design the process

___ **Determine the roles and decision making processes** that will yield the most effective information gathering, analysis, and decision making to drive the process.

___ **Develop a timeline** that meaningfully engages multiple perspectives and ensures approval prior to the fiscal year end.

II. Clarify context and articulate goals

___ **Assess current alignment of organizational values** to resource management decisions.

___ **Reflect on successes and failures** (programmatic and financial) and document learning.

___ **Identify opportunities, threats, and emerging trends** likely to influence your work (both programmatic and financial); articulate impact on revenue planning and cost structure.

___ **Evaluate current financial health** by analyzing current year-end forecast, current budget variances, and balance sheet strength; articulate impact on capitalization and surplus needs.

___ **Name the values, goals, and priorities** that should be reflected in this year’s budget.

___ **Identify what you need to focus on** in this year’s budgeting process, given the organization’s values, goals, and priorities.

III. Decide on the budget structure

___ **Articulate primary purposes of your budget** (i.e. funder compliance, monitoring progress on unsecured funds, testing new cost structure, managing multiple scenarios, etc.)

___ **Develop the structure** that best supports that purpose.
IV. Estimate costs

__ Name cost center categories based on your budget structure (i.e. program/shared /admin/fundraising; fixed/variable/pass-through; project-specific; change capital, etc.).

__ Review compensation structure and staff time/deployment in context of organizational values, goals, and priorities. Identify compensation/staffing priorities for the coming year.

__ Calculate known/steady expenses for the coming year (including increases in rental space, estimates for insurance premiums, planned software purchases, etc.).

__ Conduct deeper research and/or analysis on areas of particular risk (i.e. new/unknown costs, areas of prior year over- or under-spending). Develop support schedules that substantiate areas of greatest dollar amount and risk.

__ Develop support schedules that substantiate areas of greatest dollar amount and risk (i.e. enrollment expectations, release schedule for restricted funds, detailed fundraising plans, foundation prospect likelihoods).

__ Design cost allocation process, if applicable.

V. Forecast income

__ Calculate known/steady income for the coming year (including secured contracts, multi-year restricted grants, steady fees, baseline contributions).

__ Conduct deeper research and/or analysis on areas of particular risk (i.e. contracts to be secured, new or increased fund development efforts).

__ Develop support schedules that substantiate areas of greatest dollar amount and risk (i.e. enrollment expectations, release schedule for restricted funds, detailed fundraising plans, foundation prospect likelihoods).

VI. Draft budget and document decision points

__ Discuss potential risk areas in income and expense along with analysis of current context and determine level of risk tolerance.
__ Create a consolidated budget spreadsheet, including any potential scenarios and all support schedules that were developed during the process.

__ Develop initial draft and verify that it addresses the values, goals, and priorities named.

__ Share draft with staff teams and/or board committees for feedback and refinement.

__ Adjust draft as needed to account for feedback and ensure alignment between named values, goals, and priorities and capacity/funding.

__ Document all assumptions and potential decision points.

VII. Adopt and implement

__ Present budget to the board for approval, focusing discussion on potential decision points and areas of risk to be monitored.

__ Clarify roles and decision making processes to support effective budget monitoring.

__ Design reports for budget-to-actual monitoring, determine timeline for distribution, and process for feedback.

__ Maintain rolling projection, updated as new information comes in.

__ Monitor reports regularly and respond to changes as needed.
# EXERCISE: Planning Your Budgeting Process

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<tr>
<th>Priority Level</th>
<th>Task</th>
<th>Notes</th>
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<tbody>
<tr>
<td></td>
<td><strong>Design the Process</strong></td>
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<td></td>
<td>Determine roles and decision making</td>
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<td></td>
<td>Develop a timeline</td>
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<td></td>
<td><strong>Clarify Context and Articulate Goals</strong></td>
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<td></td>
<td>Assess alignment of organizational values</td>
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<td>Evaluate organizational financial health</td>
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<td>Name values, goals and priorities the budget should reflect</td>
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<td>Identify what to focus on</td>
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<td><strong>Decide on the Budget Structure</strong></td>
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<td>Articulate your budgeting process’ primary purpose</td>
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<td>Develop the structure to support that purpose</td>
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<td></td>
<td><strong>Estimate Costs</strong></td>
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<td>Name cost centers</td>
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<td>Review staff time and compensation structure</td>
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<td>Calculate known and/or steady expenses</td>
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<td></td>
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1 = must have   2 = nice to have   3 = maybe later
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<tr>
<td>Create consolidated budget spreadsheet</td>
<td>2 = nice to have</td>
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<tr>
<td>Develop initial draft of budget; align with values, goals, priorities</td>
<td>3 = maybe later</td>
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<td>Share draft with staff and board; collect feedback</td>
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<td>Adjust the draft as needed</td>
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<td>Document assumptions and decision points</td>
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<td>Adopt and Implement</td>
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<td>Clarify roles and decision making processes for budget monitoring</td>
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<td>Design reports for budget-to-actual monitoring</td>
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<td>Maintain rolling projections</td>
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<td>Monitor budget-to-actual reports regularly</td>
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**Action Steps:**

Three things I will take back to my organization from today’s session include:

1. ______________________________________________________________________________________
   ______________________________________________________________________________________
   ______________________________________________________________________________________

2. ______________________________________________________________________________________
   ______________________________________________________________________________________
   ______________________________________________________________________________________

3. ______________________________________________________________________________________
   ______________________________________________________________________________________
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