



Nonprofit Budgeting Part 2: Building Better Budgets

CompassPoint Nonprofit Services

500 12th Street Suite 320
Oakland, CA 94607
ph 510-318-3755 fax 415-541-7708

web: www.compasspoint.org
e-mail: workshops@compasspoint.org
twitter: @CP_Change

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Nonprofit Budgeting Part II: Building Better Budgets

As our organizations evolve many of us are searching for budgeting tools and approaches that are more adaptive than predictive, and that position us for more inclusive decision making and longer-term planning for organizational health and sustainability.

This workshop is designed for people who are leading organizational budgeting efforts, and are often responsible for designing both the tool and the process. Ideal participants will be actively looking to revamp a budgeting process and/or tool that has grown stagnant or no longer serves the needs of the organization. We will deconstruct the traditional methods and tools of budgeting and explore new possibilities for managing our resources in ways that are deeply aligned with our values and impact.

Learning Objectives

By the end of this workshop you will:

- Be inspired to develop impactful budgeting process, tools, and reporting;
- Increase your skill in communicating about the budget in order to build a culture of learning and shared leadership throughout the organization;
- Use the budget to spark new thinking for powerful conversations with funders and donors;
- Explore new ways of thinking about nonprofit budgeting and resource management.

My learning intentions for the day:

Nonprofit Budgeting Part II: Building Better Budgets

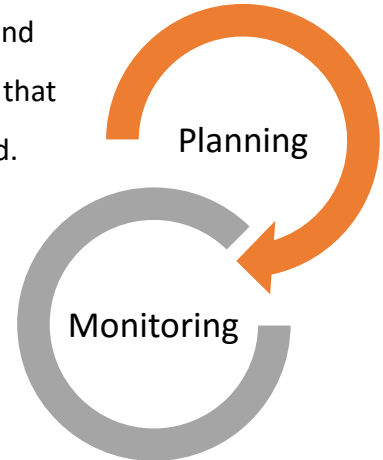
The annual budget is the financial reflection of what a nonprofit business expects to accomplish over a 12-month period. For many nonprofit leaders, budgeting is the most comfortable and interesting part of financial leadership. Done effectively, the budgeting process actively engages many staff and 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.

7 Stage Budgeting Process



Covered in Part I: Budgeting Basics

Introducing basic terminology and budget structures for both designers and participants of budgeting processes.

Covered in Part II: Building Better Budgets

Exploring the details of designing or refreshing a budgeting process and/or tool, primarily for people leading the 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: Values Alignment

As you prepare for your annual budgeting process, reflect on your organization’s articulated values, and consider how they may influence your budgeting process, as well as implications for generating and distributing resources. As you think about these values, try to identify specific examples of where the organization really lived into this value in the last year and where we fell short. Which values do you need to tend to most deeply this year and why?

Organizational Value	Reflections
	<i>What does this value mean to you? How is it expressed at your organization?</i>
	<i>How does this value connect to how we generate and distribute our resources?</i>
	<i>How will we live into this value in our budgeting process?</i>

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EXERCISE: Reflection on Current Organizational Context

When launching a budgeting process, it is valuable to step back and reflect on the successes and failures of the prior year and assess the internal and external trends that are likely to inform the organization’s work in the coming year. This can be a generative way to launch an inclusive process, by bringing a variety of perspectives to the table to discuss the various elements that might influence the organization’s resource planning for the coming cycle. In preparation for such a conversation, each person might reflect on the following questions, highlighting what they see as most important from their perspective in the organization.

Identify...	and reflect on...
Past successes	<i>How did this success contribute to our intended impact as an organization? What factors contributed to the success of this effort? What might we need to do more or less of to fuel more opportunities like this?</i>
Past failures	<i>What went wrong? What did we not anticipate? What can we learn from this? What specific changes will we make to our programs or operations to ensure it doesn’t repeat?</i>
Known factors	<i>What changes for next year have we already committed to implement? Are we launching or sunsetting any programs, partnerships, or initiatives? How will this affect the resources needed and/or how they will be distributed?</i>
Emerging trends	<i>Thinking about the community/field/movement that we work within, where is the momentum that we can leverage to extend our impact? Is our current approach on the leading edge of our field or becoming stagnant? What new initiatives or funding trends in our field will affect our work?</i>

EXERCISE: Name Goals and/or Priorities

In this exercise, draw from your reflection on the current organizational context to identify where your organization needs to focus its attention in the coming year. It may be helpful to think of these as “goals” (specific deliverables or results you aim to achieve) or “priorities” (specific areas of attention or development for the organization). This will likely include a mix of programmatic, financial and/or organizational development priorities for the coming year.

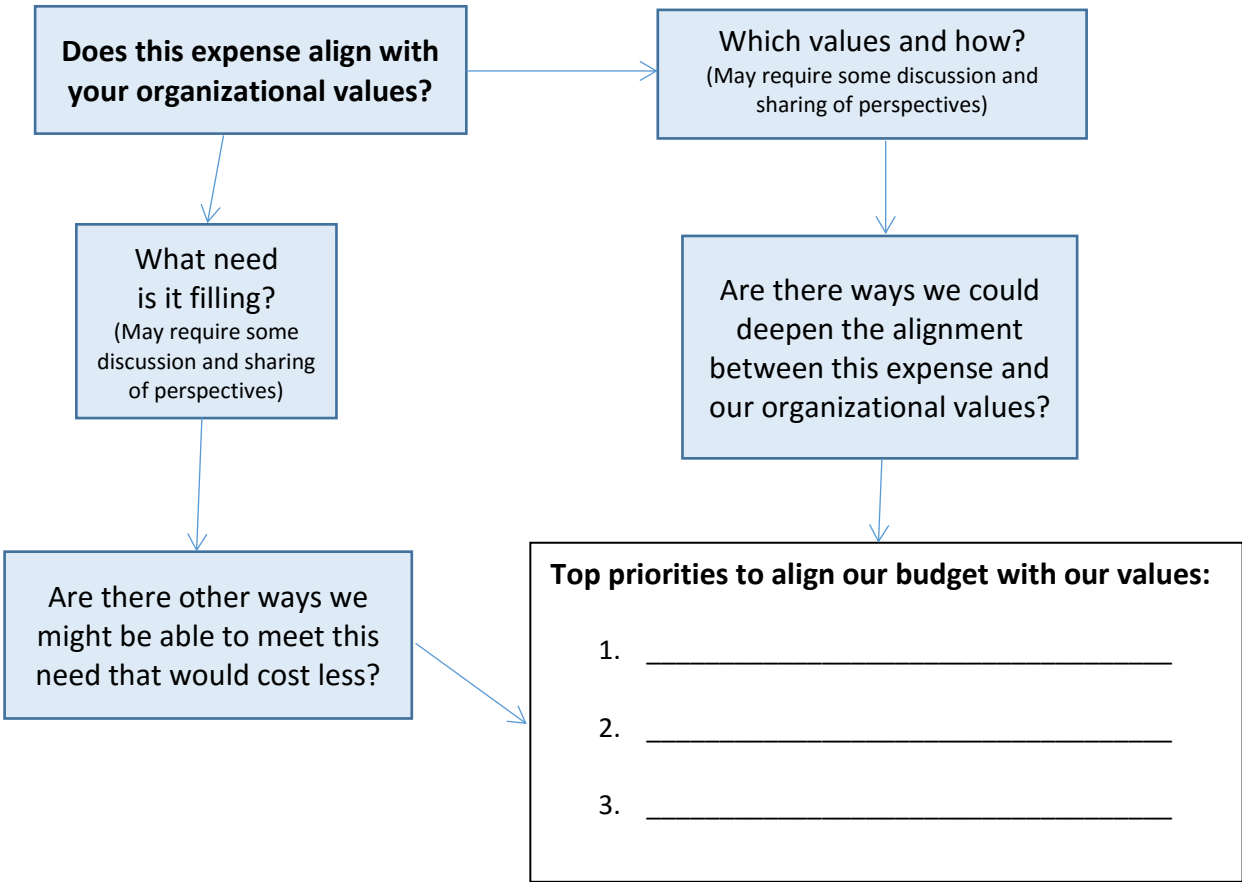
GOAL: What do we expect to accomplish? PRIORITY: What do we need to focus on?	IMPACT: How might that influence our budget planning for the year?

Determining Areas of Focus for Expenses

When thinking about where to focus your time and energy in planning for expenses, it can be useful to assess which areas of expense are the most impactful and/or potentially volatile. These tend to be the areas that will require the most planning and consideration for potential scenarios. The questions below can spark deeper conversations about how various types of expenses are aligned (or not) with the organization’s values. The chart on the next page can help with a high-level assessment of where the flexibility (and risk) lies within your current cost structure. These types of assessments will help you to think about how to design a tool and process that highlights these critical areas.

EXERCISE: Values Alignment

Looking over the expense line items in your current budget, consider the following:



EXERCISE: Risk/Opportunity Assessment for Expenses

To complete this analysis, reference the current year’s budget or a recent budget-to-actual.

Expense Grouping	% of Total	Commitment	Variability	Prior Year Performance	Risk factor

Instructions for each column:

Expense: Identify your 3-4 largest expense categories. Sometimes you may want to group related categories together. For example, you might group together all facility-related expenses or all personnel-related expenses. There is no “right” way to group expenses – it will often vary depending on the organization’s purpose and its stage of development. Not every expense line item will be represented here – some of the smaller line items do not need to be included unless it’s an area where you anticipate additional investment this year.

% of Total: Calculate the percentage of the organization’s total expense for each of these grouping areas. Enter each grouping in order from largest to smallest. This helps to see the relative proportion of the organizational resources for each group, which can be a consideration in determining where to focus your efforts.

Commitment: Assess the level of commitment for each group of expenses, using the following scale. This gives you sense of where there may be some leeway or flexibility in cost planning.

- 1 = fully (e.g, rental expense when you are mid-way in a lease agreement)
- 2 = somewhat (e.g., positions that are only partially staffed)
- 3 = not at all (e.g., new contract with a consultant, not yet executed)

Predictability: Consider the level of predictability for each group of expenses. Are they easily predictable or do they vary widely based on program enrollment, usage, or other factors?

- 1 = highly known (e.g, insurance, rental expense)
- 2 = somewhat known (e.g., health insurance, travel expenses)
- 3 = not well known (e.g., expenses for a program still in design phase)

Prior Performance: How well did you predict this expense grouping in the prior year.

- 1 = easy to hit budgeted targets
- 2 = some variance from budgeted targets (high or low)
- 3 = unexpected variance from budgeted targets (high or low)

EXERCISE: Risk/Opportunity Assessment for Income

To complete this analysis, reference the current year’s budget or a recent budget-to-actual.

Income Type	% of Total	Commitment	Variability	Prior Year Performance	Risk factor

Instructions for each column:

Expense: Identify your 3-4 largest income types (foundation grants, earned revenue, etc.). Not every income line item will be represented here – some of the smaller line items do not need to be included unless it’s an area where you anticipate additional investment this year.

% of Total: Calculate the percentage of the organization’s total income for each of these grouping areas. Enter each grouping in order from largest to smallest. This helps to see the relative proportion of the organizational resources for each group, which can be a consideration in determining where to focus your efforts.

Commitment: Assess the level of commitment for each group of expenses, using the following scale. This gives you sense of where there may be the most risk in revenue planning.

- 1 = fully secured (e.g, restricted grants or contracts secured in the prior year)
- 2 = partially secured (e.g., sponsorships for an event)
- 3 = not at all (e.g., fundraising targets for the year)

Predictability: Consider the level of predictability for each group of expenses. Are they easily predictable or do they vary widely based on program enrollment, usage, or other factors?

- 1 = highly known (e.g, restricted grants or contracts secured in the prior year)
- 2 = somewhat known (e.g., a regular, well established annual campaign)
- 3 = not well known (e.g., a new fundraising campaign)

Prior Performance: How well did you predict this income stream in the prior year?

- 1 = easy to hit budgeted targets
- 2 = some variance from budgeted targets (high or low)
- 3 = unexpected variance from budgeted targets (high or low)

EXERCISE: Reflection on Risk/Opportunity Assessment

Looking over the assessments on pages 12 and 13, begin to identify the areas of the budget that may be most important for you to attend to this year. Often, this requires that you dig deeper into what assumptions or knowledge was underneath your 1-3 ratings. The following questions may be helpful prompts.

Commitment: For areas that are unsecured or not fully committed, how late in the year will these figures be known? Does some of the unsecured funding align to the not fully committed expenses in ways that would trigger an if-then scenario? How risky do these areas seem, given the organization’s history and current internal and external context?

Predictability: For areas that are difficult to predict, what drivers are likely to cause variance? What scenarios could be built based on those drivers? What additional research can be done to contribute to solid estimates? What monitoring tools and plans need to be put in place to tend to these areas specifically?

Prior Year Performance: What was learned by any big surprises last year? How will this learning carry forward into this year’s planning? Was this a one-time anomaly or is there reason to expect it is an indicator of a changing environment?

Top focus areas based on greatest risk/opportunities:

1. _____
2. _____
3. _____

EXERCISE: Planning Your Budgeting Process



Task	Priority Level			Notes
	1	2	3	
Design the Process				
Determine roles and decision making				
Develop a timeline				
Clarify Context and Articulate Goals				
Assess alignment of organizational values				
Reflect on successes and failures				
Identify opportunities, threats, emerging trends				
Evaluate organizational financial health				
Name values, goals and priorities the budget should reflect				
Identify what to focus on				
Decide on the Budget Structure				
Articulate your budgeting process' primary purpose				
Develop the structure to support that purpose				
Estimate Costs				
Name cost centers				
Review staff time and compensation structure				
Calculate known and/or steady expenses				
Conduct research and analysis on areas of risk				
Develop support schedules where needed				
Design cost allocation process				
Forecast Income				
Calculate known and/or steady income				
Conduct research and analysis on areas of risk				
Develop support schedules where needed				

Task	Priority Level			Notes
	1	2	3	
1 = must have 2 = nice to have 3 = maybe later				
Draft Budget and Document Decision Points				
Discuss potential risk areas and determine level of risk tolerance				
Create consolidated budget spreadsheet				
Develop initial draft of budget; align with values, goals, priorities				
Share draft with staff and board; collect feedback				
Adjust the draft as needed				
Document assumptions and decision points				
Adopt and Implement				
Present budget to board for approval				
Clarify roles and decision making processes for budget monitoring				
Design reports for budget-to-actual monitoring				
Maintain rolling projections				
Monitor budget-to-actual reports regularly				

Action Steps:

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

1. _____

2. _____

3. _____

Appendix: Nonprofit Budget 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 fulfil 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.