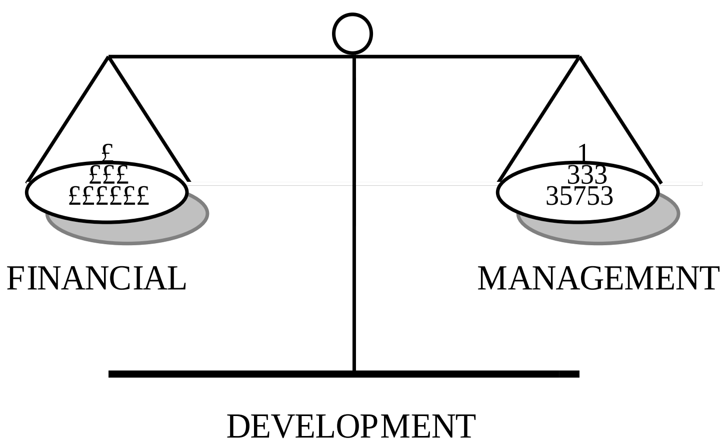
# FINANCIAL MANAGEMENT DEVELOPMENT

# CHARITY MANAGEMENT

# NO 704

# BUDGETING AND PLANNING




**ONE OF A SERIES OF GUIDES FOR**

**FINANCIAL MANAGEMENT DEVELOPMENT**

**FROM**

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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

# BUDGETING AND PLANNING

## OVERVIEW

Charities and other Not For Profit organisations face similar financial and reporting issues to ordinary businesses. However in the area of Budgeting and Planning they have to contend with specific problems which are unique to their way of working. Details on what budgets are for; how to create them and how to use variance analysis are included in the Management Reporting section of this website. Other papers in this section on Charity Management cover some specific Financial Issues relevant for Charities. This document sets out some key areas which those responsible for Charities and Not For Profit organisations may find helpful to consider when reviewing their future financial plans.

Throughout these documents the word Charity is used to cover the whole range of Not For Profit organisations and Trustees used for those responsible for them. A good Trustee will want to know more than just the past cash inflows and outflows. Trustees have a planning role, which includes the approval of the first step in detail (the Budget). The Bible says no one sets out to do something without planning the cost (Luke 14:28). If they do they run the risk of looking foolish.

## WHAT A BUDGET IS (and what it is not)

A budget is the financial expression of what you intend to do. It is not a licence to spend or a set figure not to be deviated from. Charities are not like Governments or large corporations, where the approach is to deliberately overbid for resources and then ensure you spend the money because if you underspend, "they" will cut you back next year. This approach is insane and can only exist long term within an organisation which prints money. It is vital for the health of a charity that the following budgeting rules are understood:

1. The objective of a budget is to help plan and control expenditure. It is a means to an end, not an end in itself. "Give me good actuals, not good budgets."

2. <u>Your</u> budget is the financial outcome which <u>you</u> expect to happen as a result of things <u>you</u> intend to do. The only budget worth using for management purposes is therefore one which <u>you</u> believe to be the most likely.

3. Spending up to budget (i.e. deliberately spending money unnecessarily because that is what has been allocated) can never be justified.

At this point it is worth noting that sometimes plans are produced for specific purposes e.g. as part of a bid for grant funds. These are not budgets. They contain hopes, aspirations and estimations of what will be done if the application is successful. In many cases they will be constructed in the knowledge that the full grant will not be allocated and they will therefore contain "padding" which will be dropped if funds are unavailable. Such documents are not necessarily the best for management purposes, since they are not necessarily realistic.

 

A good Budget will make reasonable estimates regarding the success of such bids and the resulting likely expenditure. In some cases two budgets may be necessary if a particular bid is so important that it would have a major impact on activities. One budget will be "if we are successful"; the other will be "if we are unsuccessful".

Some grant making organisations consider the "Application" as a straight jacket and then force the recipient into spending money in the exact way that it was described in the "Application". In this circumstance "spending up to budget" becomes part of the condition of retaining the funds and sub optimal use of charitable funds becomes likely. It is important that agreement is reached that what matters is outputs i.e. achievements, not inputs i.e. money spent. To do otherwise is to run the risk that variance reporting will be constrained, thus depriving the reviewer of valuable management information on the results of activities. To avoid this Grant Funders will often specify that the money is given on a restricted basis. This then needs to be accounted for separately in "Restricted Funds" and this preserves the money arising from any underspend in the charity whilst allowing the charity the opportunity to spend the money in ways which are in furtherance of the intentions of the grant maker but possibly not in the exact way that the original application specified. In many commercial organisations a similar approach is adopted by allowing the carry forward of budget underspends for specified purposes.

## DEMAND IS INFINITE, RESOURCES ARE NOT.

In most charities there is no limit to the good they could do if resources were available. We would like to feed the world but we only have £1,000. Therefore a decision needs to be made whether to give £100 each to 10 people or to give £1 to 1,000 people. In addition if £10 is spent on the meeting deciding what to do then there will be less available to do it. This is very different from the commercial world where the main constraint is sales income and if you sell more you then have to spend more on production, but that is acceptable because the extra sales mean there is more cash to spend. In a downturn the opposite occurs. It is also different from the Government sector where if resources are limited, demand is controlled by the creation of queues.

This has three implications for charities. We will look at each of these in turn.

1. Plans should clearly state the limits on activities - in terms of outputs or inputs
2. Priority Based Budgeting is essential
3. Income and Outgoings have to balance in the long term.

### Plans should clearly state the limits on activities - in terms of outputs or inputs

It is important that there is an agreed view on what will and what will not be done. In some charities this is set out in the Governing document e.g. by geographic area. In some cases the budget will allocate a specified amount e.g. grants of £100,000 will be made to evangelising agencies. Even so the operating plan for the next twelve months (the budget) should state the key things which the charity intends to do, how, who for, using which resources and how much it expects to spend. Commitments to large projects should only be made if it is certain that the resources to complete it will be available. Decisions need to be made in advance; as saying yes to one spending proposal involves saying no to another.

 

**Priority Based Budgeting is essential**

Incoming resources are often unreliable in charities. Legacies and donated income in particular are difficult to forecast. Reasonable assumptions can be based on past data but it is sensible to have a budget which includes informed flexibility. Thus "If funds permit we will spend £10,000 on refurbishing the Laundry, if not we will do it next year" is a perfectly acceptable comment. It is sensible if the first call on budget funds is specified for ongoing activity costs and the remainder then allocated to discretionary projects in priority order. "Income is expected to be £120,000 so we will make 10 grants, but if income is only £100,000 we will not make grants 11 and 12."

**Income and Outgoings have to balance in the long term.**

In the short term it is reasonable for income and expense to be different. Charity reserves are the result of past surpluses. They can be drawn on if necessary to allow an overspend in any one year. The Charity Commissioners ask charities to state their policy on reserves. This forces Trustees to consider what is appropriate for their charity. Keeping reserves sufficient to cover six to twelve months operating expenditure may be reasonable, particularly if the charity has paid staff. Keeping excess reserves is unfair to the funders, keeping no reserves is potentially risky.

**TIMING**

In charities it is common for the timing of spend to be affected by events, delay in grant receipts, lack of personnel etc. A good set of budget assumptions will state any key milestones and give an indication of the impact of timing changes. A good budget commentary will need to draw readers' attention to the implications. "We have a surplus this month because we did not spend the training budget. However next month we will have two lots of training so the cumulative spend will be in line with budget."

Notice that a timing difference due to cashflow should be accounted for properly if the charity is using accruals accounting. "Income is down this month because the local authority grant did not arrive until after the month end." is not correct, since the grant (assuming it was for activities during the month) should have been accrued for.

**WE WILL DO THAT IF IT IS SELF FUNDING**

Specific projects may require specific fundraising. These are often better budgeted and reported upon separately. Spending on fundraising is effectively a commercial decision and the Trustees will wish to use the normal principles of break even and relative contribution analysis to help decides how much to spend and on what to spend it. In particular they need to consider if in their circumstances total funds are effectively limited and therefore the collection mechanism should be the most cost effective, or whether they are in a truly competitive bidding situation.

 

## DO NOT FORGET CASH

For charities using accruals accounting it is important that the budget distinguishes between Revenue spend (costs) and Capital spend (purchase of assets) in the budget. However the cashflow forecast needs to be prepared to ensure that the cash resources are sufficient at any one time to meet the expected need. If you are to create a new building it is important to raise the money first, rather than afterwards, unless you have a borrowing facility set up, and even then the bank will want to see a sensible forecast backed by reasonable assumptions.

## USE GRAPHS

Graphs, whether of individual budget lines or of total income and expense, are particularly useful both when preparing a budget and reviewing actual results against budget. They help identify trends and spot anomalies. In particular a rolling twelve month graph irons out seasonal fluctuations and enables the reviewer to make informed predictions about the future.

## BUDGETS ARE GUIDES NOT TABLETS OF STONE.

The one certainty is that the result for the year will not turn out to be the same as the budget. If it does, someone is probably manipulating the actual results (spending up to budget, omitting accruals etc). Trustees have a duty to act within the objectives of their charity, but they also have a duty to act responsibly and react to changing circumstances. If there is a budget for repairs but no repairs are needed it would be irresponsible to spend money repairing unnecessarily. The Trustees are not driven by Shareholders' demands to maximise long run profits, but by a desire to consider stakeholders who include both providers of funds and the recipients of their activities.

As with any plan, the budget will be based on assumptions - stated or unstated. Some of these assumptions may turn out to be wrong. Few plans will state "This budget is based on the assumption that the world will not end tomorrow." even though statistically one day that will be an invalid assumption. Good budget management accepts this and concentrates on analysing the reasons for differences between the actual results and the budget with a view to taking informed action. Whether you spend more or less than your budget is less important than why you spent it. The differences between the amount actually received or spent compared to the budget can be broken down into five components

1. We did more or fewer things (Volume)
2. We paid/received more per item (Price)
3. We did something different (Exceptional)
4. We forgot to budget for something (Budget error)
5. We have miscoded something (Accounting error)

Knowing which of the above is the cause of the variance is important, but even more important is to take action as a result of receiving the information. Management, like life, is a learning process.

 

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David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website:
**FinancialManagementDevelopment.com** including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).

 