

## **Overview for Developing a Budget**

### **Operating Budget**

An annual budget is a plan for the revenue generation and spending for an organization. It serves as an outline for the year's activities, providing guidelines on how funds will be spent and setting goals for producing income. A budget with specific assumptions will provide a clear way to measure progress against that budget throughout the year.

A budget is a "best guess" on how much money will come in and where it will be spent. It is usually easier to predict expenses than revenue, but even with expenses, there can be unforeseen events that cause budget overages. Therefore, it is important to have as much information as possible when developing a budget to reduce the number of uncertainty factors. You will need past years' history of activity, detailed plans for the next year's activities (including strategic plan objectives, if a plan exists), and current information from the marketplace on costs and trends in revenue.

Zero-based budgeting is considered by some to be the ideal method – it requires that all programs and expenditures be justified from the ground up each year. This approach counters a tendency to simply add an increase to what you spent this year, and promotes more meaningful discussion and questioning about programs and expense activities. Zero-based budgeting can save money, and it is extremely helpful for organizations that are struggling to develop balanced budgets or that are facing projected revenue shortfalls, as in the recent recession. Zero-based budgeting is time-consuming, however. It can be prohibitive to do for the entire organization every year, but can be effectively applied to different departments in select years.

More common is to work from past experience to develop future projections. In reviewing history, typically you begin by looking at the prior year's budget compared to the actual revenues and expenses. Then look at the current year's budget against actual revenue and expenses to date, and develop a forecast for year-end based on actual performance. As you review the detail of the activity, look carefully at line items that were either over or under budgeted to understand why there are variances. Also look for revenue or expense items that have grown enough that they should now be budgeted as separate line items. You may find that you need to make changes in your chart of accounts based on actual operations.

The staff member responsible for each program and budget area should review the history, current year's activity, and do the planning and budgeting of the numbers for the upcoming year. The staff should provide written back-up to the numbers that articulates the assumptions used in developing the budget. If board members are involved in any areas (e.g., fundraising and marketing), staff should review those assumptions with relevant board members.

This approach to budgeting works from the detail up to a total for each area. Once you have totals, you need to look at the overall increases over the current year to be sure they make sense. For example, while each of the projected efforts for generating admissions revenue may seem reasonable, if the overall increase is 20% over the current year, it may be overly optimistic, and some of the figures should be revised downwards.

Budgeting is an iterative process. It is likely that early drafts of the budget will not balance and decisions will have to be made about cutting expenses or finding other ways to generate revenue. Organizations are often tempted to simply increase the contributed revenue goals to close the gap; more often than not, they find themselves with a shortfall at year-end because they set unrealistic revenue goals.

The board finance committee should review the projections and assumptions in detail, and assess how realistic and attainable they are. Once the finance committee is satisfied that they have tested and reviewed the budget, a summary of the budget, with written assumptions, is presented to the full board for its approval.

The schedule for developing a budget should allow enough time for the research, review by staff and board, and the inevitable iterations. Budgeting often begins 6-9 months before the end of the fiscal year, allowing time for programs to be scheduled, and, for a performing organization, subscription sales to be launched. While the budgeting gets underway early, the board often does not approve the full budget until their last meeting of the fiscal year, in order to have the latest information about how the current year's operations are going to end.

## **REVENUE**

Generally, an organization should develop the revenue projections first, and then budget expenses that fit within those revenue projections. Since earned revenue projections (and sometimes contributed projections) are dependent on the programming activity, however, it is usually necessary to go back and forth from the revenue to the expenses. After budgeting for all of the individual line items, step back to consider whether all of the increases are achievable.

**Admissions** – Admissions (ticket sales, exhibition admissions) are budgeted by considering several factors:

- Historical information: how did a similar production, event, or exhibition do in the past?
- Pricing changes
- Specific marketing efforts that will affect admission sales

Calculations and the assumptions for the budget lines should be specific and clear, so you can track performance against budget.

**Tuition, Workshop fees** – like admissions, these should be based on specific offerings, pricing changes, and reasonable assumptions on number of participants, based on experience and on any new programming or marketing efforts.

**Other Earned Revenue** – Rentals, concessions, interest income, etc. should be budgeted based on this year's forecast with adjustments for changes in programming, audience size, or any new planned activities.

### **Contributed Revenue**

Contributed revenue can be the most difficult area to budget, but again should be based on past history and on planned activities for the year.

**Government** – Budget based on past grants and what you know about future funding. In some cases you can call the funder – state arts agency, etc. to talk to the executive director or program officer to get their sense of the state of funding. They may also be able to give you an indication of timing of grant payments, which is helpful in doing cash flow projections.

**Corporate** – The corporate contribution line can be budgeted by listing all the corporations from which you've received funds and assessing what level of gift you might conservatively project for next year. Then list the new corporations that you might approach. Identify what dollar amount you might request, based on the corporation's giving to other organizations and your own contacts with them. Assume a percentage of that total new figure could be generated.

**Foundations** – You should project foundation revenue similarly to corporate contributions. If you are projecting any special project grants, be sure that new expenses connected to those projects are being budgeted on the expense side.

**Individuals (including memberships)** – Individual contributions should be broken into different categories and each should be projected separately. Look at the activities planned for individual fundraising and project the gifts accordingly. For board member donations, list the current year's gifts and then make projections for next year. Ditto for major donors (you decide what amount is considered "major"). For smaller gifts, look at the total raised from that category, and project based on planned activities (mailings, new web donations, etc.). You should look at the projected growth (if any) in the subscriber/member base, as these are your most likely prospects for new, smaller gifts.

**Special Events** – Budget these per event, again based on past experience and conservative estimates for new events.

## **EXPENSES**

Throughout the expense area, there will be budget lines where research, i.e. phone calls, should be made to vendors concerning future pricing. While this will pertain most to administrative lines and perhaps to marketing lines, there may be examples in all areas.

Where you don't have sufficient information on potential increases, determine an inflation rate, if any, to use on those expense lines. That percentage should be agreed upon with the finance committee.

There are a number of expense lines that should be budgeted in relation to revenue lines: credit card fees are based on projected revenue in sales; program printing is based on projected admission numbers; concession expenses (and revenue) also relate to audience numbers.

**Salaries and benefits** – Typically, staffing increases and salary increases are determined based on the overall budget's ability to afford increases. You should call to get as much information as possible on potential increases in various taxes and benefits – FICA, unemployment insurance, workman's comp, disability, life, health, etc.

**Program** – Detailed budgets for each production or program activity should be developed with as much information as possible from the program or artistic director. Wherever possible, contractual fees should be negotiated or estimated for guest artists, rentals, etc. Look at past program activity for comparable costs and to be sure you have thought through all possible expense lines (e.g., renting sound equipment for a first musical event).

**Marketing** – What you spend on marketing frequently translates to earned revenue. You can always spend more marketing dollars – the challenge is balancing the risk of activities that have unquantifiable impact or unknown potential with those activities known to generate sales. For each sales area (performances, exhibitions, education programs) you should develop the marketing plan with detail about each of the activities (i.e., brochure mailing to yyy lists and xxx households, social media, advertising, etc.). The costs for each of these activities should be estimated based on past history and quotes from vendors as possible. Look into postage and mailing house costs, media rate increases, etc. and include regular website expenditures. When budgeting mailings, for both marketing and development, don't forget to consider growth in the number of households in your database.

**Development** – You take a similar approach to development expenses as to marketing expenses. Lay out the fundraising plan for the year, listing what activities will be undertaken to cultivate, generate, and acknowledge gifts in each category. Government grants will require the least outlay, individual solicitations the most.

Review the schedule of development activities with the marketing schedule to ensure there are no conflicts (two mailings going out to subscribers or members at the same time) and to maximize the results of both (i.e., plan for an individual fundraising appeal to hit right after a program you anticipate will be well-received or after a big press announcement).

**Administration** – Past history and future quotes or estimates are most helpful here. Contact utility companies, insurance brokers, auditors, landlords, organizations in which you are a member to ask about future increases. Look at past history of usage for office supplies, janitorial expenses, bank fees, general office maintenance, general postage, etc.

Be sure to factor in any changes in staffing or program activity that might affect general administrative expenses. For example, adding a touring production not only increases production and marketing expenses, but also may boost phone, postage and other office expenses.

Computer software should be upgraded on a regular basis to keep current, and may be considered part of an operating budget, rather than a capital expense, depending on the amount and frequency of replacement. For example, a \$1 million organization using QuickBooks for accounting software and upgrading the version every year or two, would consider the upgrade price of several hundred dollars (or only \$50 - \$125 for 1-3 users at a nonprofit through TechSoup.org) as an operating expense, while a larger organization with a more expensive package might have an upgrade cost of several thousand dollars and consider it a capital expense.

Outstanding debt should be scheduled to show both interest and principal payments for the coming year. Interest expense is part of the operating budget; principal payments are a balance sheet transaction, but you have to generate additional cash beyond the operating budget to cover those payments.

Depreciation should be budgeted based on the depreciation schedules developed with the auditors. Often it is shown as a separate line under expenses. It is a non-cash item; however funding it each year can provide money for capital improvements and equipment purchases.

**Contingencies** – You should try to budget for contingencies. It is often difficult to include an overall contingency line, and it may be easier to build a percentage contingency into the program budgets, where there are more likely to be unforeseen expenses.

### **Capital Budget**

In addition to the annual operating budget, organizations should have a multi-year schedule of planned capital expenditures. Begin with the list of property and equipment that you already own, listing it by category: computers, other office equipment, production equipment, etc. List the current value and a best guess on the future replacement date. Then add to the list any new equipment that is desired. Staff in all departments should be consulted on the estimates of replacement dates and the new equipment lists.

For leased or owned property, there should be a section on anticipated improvements, e.g. replacing the roof, new carpeting, new outdoor signage, etc., etc.

Project the purchases over the next five years, with a column showing purchases that would happen beyond the five-year period (roof replacement, etc.). Each year, you will determine how much is available for capital purchases, and then review the list, pushing items forward or back, depending on need and affordability in the current year, and adding any new items to the schedule.

*Regular reinvestment in technology (computers, databases and other software), both in the office and for program activity, has become critically important for organizations to run efficiently, reach audiences, and analyze, understand, and grow their revenue. Budget for regular upgrades!*

The revenue to cover capital expenditures can come from multiple sources: funding depreciation each year and using the cash for new purchases; soliciting grant funds for specific purchases; setting aside operating surpluses into a capital projects fund; or through capital fundraising.

The board sets a policy on what level of expenditure will be capitalized, rather than expensed, depending on the size of the organization. For example, in a smaller organization, equipment purchases over \$500 may be considered capital purchases and depreciated while those under that amount will be considered an expense. Usually the operating budget includes funds for the purchase of smaller items that are under the set limit.

The finance committee should review the capital budget and recommend it to the full board for approval each year.