Roadmaps
A Guide for Intellectual Entrepreneurs

Budgeting Basics

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By Gary Leff

Budgeting Matters for the Whole Organization

Budgets are really just numerical representations of a plan. They’re a short hand way to capture what commitments or plans have been made, and track progress against the plan.

They aren’t the last word on the subject – you can spend money and not actually reach your goals – but tracking budgets helps you

- Identify where you’ve made commitments but aren’t following through (one likely reason for overspending)
- Identify where you’ve made decisions without updating your plan (overspending relative to budget), and may need to update board members or - if cash is tight – make adjustments elsewhere to your plans
- See tradeoffs between different investments you’re making in the organization, assisting you in making opportunity cost decisions.

None of those are purely about ‘accounting’ although budgets are certainly a part of finance, audits, and stewardship of donor resources.

They’re much more though – a quick, condensed way of capturing what’s going on in the organization that allows leadership to make important decisions about tradeoffs and investments.

And that’s why I often feel like too many CEOs ignore budgets and financials, or pay them only cursory attention. The sense is that the numbers are complicated or aren’t helpful. But it is rarely the case that accounting rules stand in the way of getting better understanding from your financial statements. If your financials aren’t giving you a solid understanding of the organization, it’s likely the way the financials are set up – and certainly not accounting rules – that are the reason for this.

Non-profit accounting is, for the most part, simple. We run largely cash businesses, with contribution revenue and expenses over the course of a single fiscal year. We may receive multi-year pledges, and may make commitments one year for payment in the next, but for most organizations – especially organizations that do not have budgets of US$5 million or greater – those tend to be limited to just a handful of instances and easily tracked.

And it’s best to keep accounting as simple as possible, not just for the understanding of the CEO but also for any fundraisers or program directors on the staff as well. Donors are one of the primary external audiences for financial statements, so it’s helpful if fundraisers can be conversant in the documents. Plus if they’re developing funding proposals, it helps to have a firm grasp on what sort of resources are needed to accomplish the project they’re seeking funding for.

For project directors, understanding what their commitments are for the project on the one hand, and what the cost of that project is anticipated to be, helps allows those individuals to raise their hand and update the organization when facts on the ground lead them to deviate from expectations – maybe they’re more efficient than expected, freeing up resources for the next highest use in the organization, or maybe program participation is going above budget and someone needs to decide whether the resources are there to support it, or if the tradeoff would mean giving up other important projects and so attendance at a conference might need to be cut off, for example.

What a Budget is – and What a Budget Isn’t

The worst question I ever get asked is, “how much money is left in my budget?” The offending staff member usually thinks they’re asking a simple question, where the answer will tell them if they are allowed to spend
money on whatever they’re considering.
What they don’t know is that they’ve just asked me for a broader discussion about the purpose of budgets and how to use them effectively.
Money in a budget shouldn’t be *permission to spend*. Instead, it’s a best guess 12 months in advance (the beginning of a financial year) of what the end of the year is going to look like, based on plans for the year. The budget figure, in almost all cases, will be wrong – because there’s uncertainty in nearly every program.
As the year goes on we develop a better understanding of what the program will cost, and update our projections accordingly. If a program is above – or below – budget that needs to be understood inside the organization.
Having money left over doesn’t mean that the program can spend it on something else. It means that the organization has additional resources, and should purpose them to their next highest valued use to accomplish the group’s objective – whether that’s a different program, building up reserves for financial stability, or spending more money on meals at the conference that was under spending its budget.
On the other hand, *not* having money leftover in a budget ought not mean that a program shouldn’t spend.
If there’s an opportunity that wasn’t originally contemplated in the budget, the opportunity should be considered. And if it’s a good enough bet for the organization, then take funds out of reserves (if there are any) or cut a lower-valued activity the organization was planning to undertake.
I often tell staff members that they have permission to do anything that makes sense. And they do not have permission to do anything that does not make sense. If they are at all in doubt as to which category an activity falls into, they need to consult with their supervisor, and that supervisor may need to consult the organization’s Chief Operating Officer (in many smaller groups those roles may be combined).
Put another way, budgets are *projections* and not *permission*. The goal isn’t to use up the budget; it’s to undertake a successful project that advances the mission. Seeing money ‘left in a budget’ says that there’s a question that needs to be asked (how best to utilize available resources) rather than offering an answer (you may spend).

**Budget Projections Need to be Updated Continuously**
Budgets aren’t something you do once, at the beginning of the year, and then compare things to at the end of the year to ask, *how’d we do?*
In order to be useful tools, they need to be updated frequently. You make decisions during the course of the year that change the plans you started out with. You gain information about how much projects will cost, where you may have started with only an estimate (how much will hotel rooms cost? Or paying speakers or authors? Or flights to that Atlas event?).
As you gain more information you want to *update your projections*.
Your ‘Board of Directors-approved budget’ remains frozen for the year, but next to that you want a column which represents “projected year end.” That’s the amount you now expect to spend for the year.
For each program I ask our program directors to look at how much money has already been spent, separately list how much money they have committed to spend (they might have sent a publication out to be printed, but the printing bill hasn’t come in yet so it hasn’t been paid), and how much they *plan to spend*. Those three items (have spent + committed to spend + plan to spend) add together to be the program’s *projected total spending for the year*.
And it’s necessary to do the same exercise projection for revenues, just as with expenses (only with money raised + committed + expected in place of spending categories).
I recommend going through this exercise at least quarterly. It isn’t so frequent that program staff are spending their precious time doing nothing but accounting! But it’s often enough to have a regular sense of the state of the organization’s finances, and with enough advance notice to do something about it – ie. cut projects if you’re overspending and don’t have the resources to cover, or add new program investments if it turns out there’s extra funds available.

Doing this, you shouldn’t ever be caught by surprise at your year end. You can make decisions as the year goes on, continually update your expectations, and communicate those with any stakeholders (like board members) who need to know.

Organize Your Budgets and Accounting to Give You the Best Information Possible to Make Decisions – Not to Paint Your Organization in the Best Possible Light

In most cases you can organize your financial statements any way you wish. There are some accounting rules, which will vary by country, but by and large your financial statements are yours and should be organized to reflect the way that you do business.

(And to the extent that you ever do run into accounting rules that dictate things a certain way, for internal purposes you can still organize them however you wish – and include a sheet that reconciles those financials to the formal presentation. In the U.S. there are some rules about how revenue is presented in audited financials – such as donated office space – that differ from how an organization’s tax returns need to show the numbers, and the tax returns specifically include a section for reconciling the two.)

The purpose of budgets and financials are to better understand plans and manage tradeoffs and investments. Anything that takes away from that will undermine your ability to advance the mission of the organization.

And yet organizations do, sometimes, play games with the numbers so that they will ‘look good’ to outside audiences (usually donors). The most common is an attempt to make an organization look “more efficient” by showing lower than actual fundraising expenses.

For instance, one practice that can cause problems is sometimes known as ‘joint cost accounting.’ If you have a fundraising mailing that talks about programs, and decide to allocate some of the cost of the mailing as a program expense (‘getting the word out about the program’) instead of entirely as a fundraising expense (which is the reason for the mailing!), then fundraising expenses will look much lower. Organizations love to then tell donors that they’re “putting all of their money into programs.”

But doing so makes it harder to understand whether fundraising endeavors are effective. The fundraising projects appear less expensive, and results look better by comparison. It’s harder to make critical decisions about the best way to invest to grow resources for the organization. It may look better in the short run, but by limiting good information, the organization limits its ability to grow effectively over time.

Most people in a position to give significant contributions understand that the numbers they see in a financial statement raise questions for them to get an answer to (is the organization spending too much on management or overhead and not enough on programs?) rather than actually giving them the answer. And many donors do also understand that organizations play games with these numbers, and so do not make decisions based solely on percentages or ratios.

An organization that fundraises primarily through the mail from large numbers of individuals will have higher fundraising costs (printing, postage) than one that relies on foundations or on large gifts from a few individuals. That doesn’t necessarily mean the group raising money from many individuals is ‘less efficient’.

And it’s only a small percentage of donors that really dig into the financials anyway (and those are the ones most likely to ask questions!). You, on the other hand, have to live with the consequences of your budgeting each and every day.

In the U.S. there are websites like Charity Navigator that primarily use ratios to come up with their rankings.
Those rankings aren’t very useful as a result. But for small supporters they represent a quick and easy way of making an imperfect judgment about an organization. So failing to ‘game the ratios’ can affect an organization. I find it’s best to meet the challenge head on through transparency on the organization’s own website – if a ratings organization gives less than a stellar endorsement, try to understand why and address it straight on rather than trying to adapt the organization’s practices to the ratings group.

**Confronting Financial Issues in a Growing Organization**

Organizations are generally started by passionate leaders in the face of an important and often intractable problem. There is urgency to make progress right now and never enough resources to take on all the good ideas that could make a difference for the organizations mission.

The last thing on the mind of the leader of a young organization is planning for that organization’s financial future. After all, it’s the mission – the future of a country even! – that’s at stake, and that’s far more important than the future of the organization itself.

But if it’s going to be a long fight, rather than an easy battle, it’s important to put good procedures in place so that the organization is equipped to make increasingly effective progress over time.

**Budget to spend only what you have, not what you hope to have.**

Some organizations take a highly conservative approach, such as refusing to go forward with a project until they have three years’ worth of funding for it raised and in the bank. That approach certainly assures they can give the project a good test, and that they probably won’t have to pull back unexpectedly.

On the other hand, there are urgent priorities now and that’s probably why most organizations were started in the first place. Waiting to get started means waiting to experiment, learn, and improve, and it means putting off achieving results. Sometimes projects that aren’t underway yet are easier to fund (some donors want to fund things that are truly new) but often times it’s difficult to secure funds for something that is only in the planning stages, and that you won’t act on right away even if they make a gift.

For an organization with money in the bank, able to act as its own investment bank to fund startup projects, it’s possible to make a commitment to a project in advance of funding.

For most groups, though, a middle ground is necessary. They raise money throughout the course of the year, consulting with their donors and basing expectations on past decisions. They make a bet about how much money they’re going to raise, and plan their spending accordingly.

The challenge with this approach is that bets don’t always pan out. There’s also a bias towards optimism. We think we can change the world, right? So it’s not surprising that we think we can convince others to support our vision as well.

When formulating budget plans, it’s important to keep that optimistic bias in check because it risks causing you to spend funds you don’t have, and brings the potential to put you in a position where you have to cut other, more valuable programs or capabilities to make ends meet (programs or capabilities that may, themselves, make you attractive to supporters in the first place).

So the simple rule is that you want to spend only the funds you are certain to raise. Seek board approval to begin program expenditures on the basis of real money in the door. Sure, fundraising may exceed projections. You can always revise your budget upward with board approval. And you can fundraise on the basis of the plan you’re trying to put into place, while operating under the more shoe string version until you’ve raised some of the funds towards the bigger vision (while showing donors both versions).

**End each year with a small surplus if you can.**

Organizations with large surpluses or large deficits tend to be unattractive to funders. A large deficit at least raises the specter of irresponsibility, and suggests that any gifts made may just replenish drained reserves rather
rather than to going towards new activity. A large surplus, on the other hand, suggests an organization may not need the money.

The natural inclination, then, is to believe that the best path is a balanced budget. My own view differs slightly. I believe that a growing organization needs to run modest surpluses in most years.

That’s because revenue and expenses are not always evenly timed throughout the year, and don’t always match up with each other either. An organization needs some money in the bank purely for cash flow purposes. If you raise $100,000 in a year, and spend $100,000 in a year, that’s great – but what if some of those bills come due a few days before revenue comes in? Having money in the bank keeps the organization running in a way that merely having pledges or receivables does not.

It also lets you make bets. While I suggest only spending the money you’re confident you have, not what you hope or project to have, sometimes you may still bet wrong. And you don’t want that to be a ‘bet the institution’ sort of mistake.

Having US $100,000 in the bank is probably perfectly sufficient for an organization with a $400,000 annual budget. But what happens when the organization has grown to $2 million? It isn’t going to survive well on that $100,000 cushion, just because expenses and revenue won’t always be timed exactly the same. Be sure to plan accordingly.

But in order for that $100,000 to grow, the organization needs to run a surplus - which is difficult to do in the face of competing, urgent priorities. My own suggestion is to plan a balanced budget, but as savings materialize during a year, resist the temptation to spend each dollar. In this manner, a healthy organization can become an even more effective organization.

Honor donor intent and ‘restricted funds’ but don’t restrict gifts more than you have to.

For an industry that depends on voluntary contributions, there’s no more crucial ingredient to long-term success than reputation. It’s important to be upfront with supporters about what you would do with their contributions, and honor those commitments. It’s also important to stay in good touch with supporters when possible, to share learning and if circumstances develop that change your recommendation about how funds should be spent, enter a dialogue with the source of that support. A reputation for keeping commitments, communicating clearly, and delivering on promises will yield greater confidence, and greater levels or support.

At the same time, and in communicating with donors, one thing that I’ve learned is that individual interests will vary, as will the desire of different supporters to place restrictions on their gifts.

Some gifts come with significant strings – honor them if you take the funds, but if a grant requires spending money in a way inconsistent with the most valuable things your organization can do to advance its mission, turn down those funds or give them back. It’s tempting to take funds for less productive purposes to ‘keep the organization running’ but such grants also divert attention -- they aren’t costless—they take management and staff time and talent and those are almost always binding constraints.

At the same time, it’s often organizations that add strings to gifts. When raising money and talking about projects, they sometimes attribute every dollar in the door as being for that project without considering all of the costs associated with that project (like the offices that staff use, the telephones, photocopiers, scanners, computers). Some donors won’t support such “overhead” but unless the prohibition is clear, it shouldn’t be added by the organization. Put a different way, don’t over constrain a gift beyond the intentions communicated by a donor. Doing so winds up boxing an organization into spending on activities that are less than optimal for the organization because “that’s all the money can be used for.” It falsely appears as though the funds carry no opportunity cost, because spending it other than the manner in which the group has restricted it isn’t possible.

A donor may indicate a desire to restrict funds, but an organization usually shouldn’t do so on their own. Even a small organization should pay attention to sound financial controls

Part of building a reputation is demonstrating that funds will be used in a responsible manner, in furtherance
of the organization’s mission, and in the manner committed to up front when communicating with supporters. Ensuring that the organization is effective means making sure that funds do in fact go towards their highest possible uses that make the most difference towards advancing the mission.

Both of these require putting in place strong financial controls. At its simplest, that means that all transactions are done as transparently as possible, and that any one person’s actions are observed by someone else without similar personal interests.

Usually that entails ‘splitting up’ financial duties. A person requesting a payment shouldn’t also be preparing the payment and signing off on making the payment. The larger the organization is, the easier it is to split up functions in this way. It’s also easier to rotate functions occasionally – the person who reconciles bank statements might not do it when they’re on vacation, and another set of eyes looks at the books.

Smaller organizations by their nature have the same person taking on multiple financial roles. But at a minimum, as a start, I advise that one person writes checks and a different person reconciles the bank statements. This helps ensure that all transactions are recorded accurately, and that all transactions are seen by someone other than the person authorizing them.

### Stretching Your Budget to Advance the Mission of the Organization

Every expense should have a purpose. That purpose should tie to the organization’s mission. We don’t necessarily question every purchase made by every employee, but every decision is open to (respectful) challenge: what was your theory about how this was going to advance a particular program or activity, that was going to further the mission, and how was it supposed to contribute at the margin more than the next best investment that could have been made with the same money?

Asking this question, and training staff to ask it, is part and parcel to ensuring a non-profit’s effectiveness (on an opportunity cost basis) and cost-consciousness. I love questioning small expenses because there’s less at stake, and also reminds everyone to think consciously about every decision – a habit which carries over to the big decisions as well.

It’s human nature to want to make some investments that feel good, or look good to peers, or make life personally more comfortable (in a way that might not tier to simultaneously making staff more productive) and vigilance remains the only way to counteract this tendency.

Buying furniture used, extending the life of a computer, and bringing in sandwiches to meetings with outside groups instead of catering can at least be a starting point – unless the person making a case for a greater level of investment can articulate how the additional marginal expense contributes greater value towards the mission.

One area where I’m always skeptical of significant spending is information technology projects. They can be important and deliver significant value, but I’ve rarely come across any that finish on time or on budget, or that yield all of the projected benefits. (As a general rule, any advocate of any project will tend to overstate its likely benefits, even unintentionally.) That doesn’t mean the projects shouldn’t be pursued – just that it’s worth applying a significant discount rate when making a decision to move forward. Projects need to have resounding benefits to make sense, especially when the cash commitment is large.

I’ve found it’s possible to make projects more attractive than they first appear simply by negotiating with vendors to lower the costs of what they will deliver, and by carefully reading contracts.

More service providers will negotiate on price than won’t. Almost anything offered by an individual paid on commission, or that’s sold by a decision-maker in a firm rather than a mere functionary, is open to negotiation. I’ve found that if I’m paying even half of list price for a copy machine it’s way too much. And any time you’re ready to come to agreement on a contract, there’s enough upside for both parties to make the project worthwhile, there’s likely a little bit of room that your counterpart still has at the end where they can reduce price. Little is risked simply by asking at the end, “I think we’re really really close but there are still some internal reservations.
I think I could overcome those if we could squeeze just another $X off the price (or provide a Y% discount on the next order, or throw in an extended warranty, or anything that’s easy for the vendor to give that may have future value).”

Finally, don’t be afraid of being forced to make tough decisions. In any organization’s life cycle there will be tough times, where it seems like impossible choices are forced. Things are rarely as bad as they seem, and sometimes those tough decisions can go a long way to reveal what the most important priorities for an organization are – and to align the organization’s activities with those priorities. Even the best organizations accumulate unproductive activities over time, which go unexamined when resources are available. Tight times, though painful for staff, can be helpful in redirecting not just financial resources but scarce management resources to their most productive activities. So push forward!

**Additional Resources**

Nonprofit Assistance Fund – Budgeting and Planning ([NonProfitsAssistanceFund.org](http://NonProfitsAssistanceFund.org))

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