

Budgeting Process Session 3

Budgeting: Overview

1. What is a budget?
2. Why are budgets necessary?
3. Budgeting cycle
4. Challenges of administering budgets
5. Elements of an operating budget

What is a budget?

A budget is:

- a. The quantitative expression of a **proposed plan** of action set by an organization's leadership for a specific period, and
- a. An aid to coordinate what needs to be done to implement that plan

Strategic and Operating Plans

A **budget** is most useful when it is **integrated with an organization's strategy**

Some questions that need to be considered:

- a. What are the organization's short and long-term objectives?
- b. How does the organization serve the interest of its stakeholders or constituents?
- a. What is the best organizational and financial structure to carry the objectives?
- b. What are the risks and opportunities of alternative strategies, and what are the contingency plans if the preferred plan fails?

Why Are Budgets Necessary?

Some organizations must have budgets to comply with laws and regulations

However, beyond a compliance role, budgets help to:

- a. Promote **coordination and communication** among the sub-units of an organization, especially to make sure that all employees understand and carry the organization's goals,
- b. Provide a framework for **judging performance** and facilitate learning,
- c. **Motivate** the organization's leadership or management and other employees

The Budgeting Cycle

Most operating budgets run through a **one-year cycle** (often called fiscal year):

1. Before the start of the year, managers at all levels consider (a) past performance, (b) feedback from stakeholders, and (c) anticipated future changes to start planning for the next period
2. At the start of the year, the leadership sets specific nonfinancial expectations for the year, these expectations then become detailed plans in terms of cash flows (income and expenses)
3. During the year, employees at various levels track and investigate any deviations from the plan

Financing, Operating, and Capital Budgets

These terms appear in the budgeting process:

- **Financing decisions** deal with how to obtain the funds that will be spent in the short and long-term (e.g., city taxes and fees)
- **Operating decisions** deal with how to use (allocate and spend) resources, typically within a one-year period (e.g., salaries)
- **Capital decisions** deal with the acquisition of resources (assets) that will be used over a long period (e.g., buildings, roads, etc.)

Five Challenges in Administering Budgets

1. Involving all the organization's levels and outside stakeholders is complicated, but it is the basis for creating commitment and accountability throughout the organization
2. It is a time-consuming process, in the private sector senior managers spend about 10-20% of their time in budgeting and financial planning departments as much as 50% of their time in managing budgets
3. Although budgets are strict goals, they need to also incorporate flexibility
4. Both the past (last year) and future expectations need to be considered in setting the budget
5. The leadership needs to decide how to deal with variances in actual versus expected revenue and expenses

Elements of an (Annual) Operating Budget

1. **Forecasted revenue**, usually broken down into its drivers and components
2. **Variable costs** that depend on revenue (can be calculated as a percentage of sales)
3. **Fixed costs or expenses** that typically do not vary with changes in revenue, at least within the time frame of the operating budget
4. An operating budget can include **non-cash expenses** (depreciation and amortization). Even though these expenses don't impact cash flow, they will impact financial performance
5. Money for the acquisition of assets or long-term projects is typically set aside in a separate budget, often called "**capital budget**"

Unique Elements of a Government Operating Budget

- Often government budgets separate income and expenses into separate “**funds**” to recognize that some income must be spent for specific purposes (school taxes or garbage collection fees), while other types of income can be used for “general” expenses
- Also, there are maximum **limits to expenditures**, for example “The City shall retain unassigned fund balance reserves equal to a threshold of ten percent of the prior three years average of general revenues”

Reflection Questions

- Why are budgets necessary?
- What are some challenges of administering a budget?
- What are the elements of an operating budget?
- What are the key differences between operating and capital budgets?