Understanding budget basics
CORE 08

This information sheet covers the following topics:

- **How to work out how much money you need**
    - Identifying different types of cost
    - Costs often ignored
    - Getting started
- **Drawing up a budget**
    - What is a budget?
    - Why do you need one?
    - Components of a budget
    - Preparing the budget
    - Forecasting cashflow
    - Expert tips on good financial practice
    - Options for creating a budget
- **Glossary of financial terms**

How to work out how much money you need

You know you need money, but you're not sure how much. Figuring this out is the first step in the budgeting process. Costing your project accurately needs to be a realistic process and it's useful to identify different types of cost.

Start up costs – a start-up budget should be established to cover things like:

- staff recruitment
- premises and equipment
- start-up advice and consultancy
- promotion, publicity and launch
- training and induction.

Capital costs - these are big, one-off items like the cost of a new building, major new equipment or other resources. It is usual practice to fundraise and account for capital items separately from revenue costs.

Revenue costs - these usually fall into two main categories:

- **Direct service costs** (these may also be called project costs) - these are all costs for running specific activities. It includes things like room charges, course materials and the time of the people involved in delivering the activity (don't forget when you're calculating staff cost, you must include the cost of people when they're ill or on holiday)

- **Indirect costs** (these may also be called management costs, overheads, core costs, or infrastructure costs) - these represent the costs and time involved in properly running and managing the organisation as opposed to the costs involved in delivering services. They include stamps and paper as well as a portion of the rent, admin staff, external consultants like accountants and solicitors, insurances, electricity, etc.

When you are calculating direct service costs, pay special attention to shared costs. The organisation may have certain resources (including people) whose work is spread across different activities. For example, a minibus might be used by four different projects within the organisation – so the running cost of the bus should be shared out among the four different activities.

Costs often ignored

In the rush to cost an idea, certain key costs are often ignored or overlooked. Here are six examples:

- Slow start costs. Projects that expect to earn income may need to take into account the fact that they will take time to build up to their full potential. The cost of a slow start – including possible short-term borrowing – will need to be included in any forecasts.

- Contingency costs. Not everything is known at the start. Things can go wrong. A contingency budget is a reserve budget to provide some protection against unanticipated costs or events. Contingency costs are usually calculated as a percentage of total turnover or the equivalent of, say, two months' operating costs kept on reserve.

- Development costs. As well as ensuring that the project has enough money to run on, it's useful to allocate some costs and time to invest in its future development. This might include resources to be spent on developing new or spin-off projects, action research and project development. A small research and development budget can act as the seed corn to support future development and ideas.

- Evaluation costs. Increasingly, funding bodies expect a thorough and independent evaluation of the project. The evaluation is a stock-taking exercise to see how the idea is working out, get feedback, look for early results and see what can be learned.

- Replacement costs. It can be useful to create a separate fund (sometimes called a sinking fund) to build up funds to pay for the eventual replacement of equipment and resources that will depreciate and need replacing over time.

- Close-down costs. For projects which only exist for a specific period of time or are reliant on very volatile income sources, it may be wise to consider the costs of having to close down. Sometimes these costs are included in the contingency budget. The close-down budget might be used to cover redundancy costs, costs involved in ensuring that users are able to transfer to another suitable service, and possibly the costs involved in the final evaluation of the project.

Getting started

It's not hard to cost your idea after you've considered everything you'll need.

- Make a list of all your anticipated costs within the categories above
- Decide if there's anything you can do without or can get donated
- Begin to consider how you are going to be able to get the money you need

Drawing up a budget

What is a budget?

A budget is part of your project plan. It's an estimate of how much money you expect to have – and spend – over a specific period of time.

Drawing up your budget is not an administrative chore that can be left to the treasurer or book-keeper. It is a clear statement of your priorities and is one of the most important processes in shaping the design of your organisation.

Why do you need one?

In order to survive, your income must be equal to or more than your expenditures. You will need a budget in order to know whether you are in good financial health or not.

Also, in order to get money from a bank or a funder, you'll probably be asked for a budget.

Finally donors will want to know if you're spending their money wisely.

Components of a budget

Most budgets contain three main parts:

- time period
- anticipated income
- estimated expenses.

The usual format for a budget is a table which has the time-frame running along the top and a left-hand column divided into two sections: income and expenditures. In each of the two main sections, there will be a listing of specific line items.

Some examples of line items which you might include in your budget are:

- salaries
- rent
- heat
- insurance
- telephone
- postage
- publicity
- recruitment
- travel
- expenses
- VAT

Preparing the budget

Budgeting is a mixture of mathematics and guesswork. Some things are known, definite and unlikely to change. Other factors are less clear and subject to uncertainty.

It's useful to record and make clear the assumptions that you are working with when drawing up the budget (eg: we assume that our local authority grant will rise each year in line with inflation).

When drawing up your budget, it is important to record benefits in-kind. So for example, if you needed some building work and a local builder offered to give his time for free, don't just ignore this in your budget. Find out how much this labour would cost if you were to pay the normal rate and record this as expenditure. Then add the same amount to your income, recorded as in-kind labour.

In some circumstances it's useful to produce budgets for the best and worst case scenarios. The best case budget is how you hope things will turn out. The worst case is the point just above insolvency and collapse.

Discussion of these possibilities can help trustees and staff identify the action needed, the importance of regular monitoring and the need for an early warning system.

Forecasting cashflow

In additional to a balanced budget, it may be worthwhile to produce a separate cashflow forecast to see if there are any patterns of cashflow that need attention.

To produce a cashflow forecast you need to estimate the likely expenditure and match it against anticipated income for each month.

Sometimes this will highlight problems. For instance, a community arts agency might spend most of its budget in the first and second quarters of the financial year organising summer festivals. But its income from grants would be paid throughout the year on a quarterly basis. A cashflow projection might show that although the budget balanced over the whole year there would be at least two months when the agency would not have cash on hand to pay its monthly outgoings. Some action would need to be taken in advance to make sure there would be money available.

Efficient cashflow demands planning, contingency planning and controlling.

Expert tips on good financial practice

- Keep accurate records of all money that comes in or goes out. This may seem obvious, but be sure you've set up a system that makes it happen.

- Review actual expenditures and resources on a regular, periodic basis and compare them with your budget. This will allow you to improve the accuracy of your budget the next time you are preparing it.

- Be realistic. It's fine to be optimistic when you're developing your vision, but when you're preparing your budget, realism is crucial.

Options for creating a budget

- Create your own financial table of anticipated income and expenditure (a spreadsheet computer package such as Microsoft Excel is ideal for this).

- Buy a book that contains budget templates to fill in.

- Buy a software package that takes you through the budgeting process step by step.

- Find a professional to help you. There are various ways to do this, for example asking at your local CVS or hiring an accountant.

Glossary of financial terms

When you first start looking at accounting matters, sometimes even the language is hard to follow. Here's a quick guide to the basic terms.

Assets - items of value the company or organisation owns. "Current" assets include things like cash and money owed to you. "Fixed" assets include equipment, property and other more permanent items of value.

Audit - an inspection of your business accounts.

Balance sheet - shows the financial position of an organisation at any given time. It compares assets (what you own or are owed) against liabilities (what you owe).

Bottom line - the last line of a financial statement which shows profit or loss.

Capital - material wealth of your initiative. In the voluntary sector, this frequently means money or grants.

Capital costs - one-off expenditures such as major office equipment or furniture.

Cashflow - how and when the money comes in and goes out. This is crucial information. Even if you've raised the necessary money, if the cash hasn't arrived in time to pay the rent, you have a problem. The ability to forecast, understand and manage cashflow is essential to your financial health.

Depreciation - as items your initiative owns decline in value over time, you can deduct a portion of their value from your total (also called "gross") profit as an expense on your taxes. This is called depreciation.

Forecast - your projection of your future financial health – how much money you expect to have collected by a certain date.

Liabilities - amounts your organisation owes (including depreciation and bad debts, i.e. money you're owed which you're never going to get)

Reserves - money you hold aside – in "reserve" – in case you need it for something unexpected.

Revenue costs - recurring expenses like telephone bills, etc .