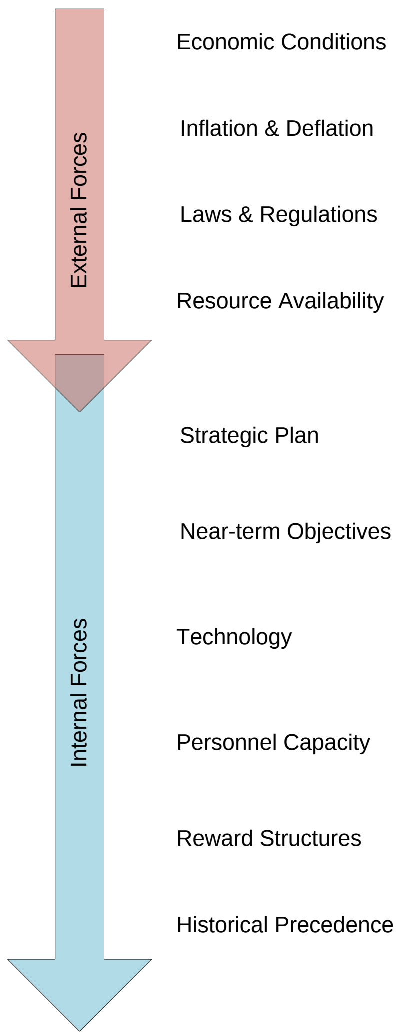
E2I Budgeting

A Better Budget Process



What is E2I Budgeting?

It stands for External to Internal with the "2" also signifying the two primary categories of forces that impact an organization's ability to produce a realistic budget. Effective budgets are accompanied by supportive language detailing various assumptions and objective data. This supportive document should follow the topic flow of the E2I forces.

External Forces

Nonprofits do not operate in a vacuum but, unfortunately, most organizations approach the budgeting process as if it does. Usually we pay attention only to the things directly in front of us that we can see and experience. Therefore, forces external of the organization are frequently ignored at potentially great cost.

Every entity is confronted with both the opportunities and threats from various external forces. These outside forces are by definition beyond the control of the organization; however, that does not mean the organization is powerless against them. As part of the budgeting and planning process, the organization should seek to determine how it will respond to changes in the greater environment within which it operates.

Consideration of external forces must be completed prior to consideration of internal forces and is represented by the downward direction of the arrow in the graphic. The four primary external forces are further described in the following sections.

Economic Conditions

The organization must answer two critical questions before even beginning to think about specific budget figures:

- What economic conditions are projected for the upcoming fiscal period?
- What impact will these economic conditions have on the organization?

This is not a binding prediction and certainly no one has a magic ball. But the general economic conditions are nonetheless important. For-profit entities frequently rely on and refer to economic forecasts in creating a strategic plan and non-profits should do the same. Expert opinions from economists are easily found in newspapers and other published journals and provide substantive information.

No matter what the organization's mission or focus, changes in economic conditions will have a monetary impact on the organization. And just because a downturn is projected, that doesn't mean your organization will have less money. Indeed, many organizations that provide essential services experience more activity and funding during times of economic crisis. So take the time to thoroughly consider all the monetary implications of economic changes both directly and indirectly.

Inflation & Deflation

Changes in the buying power of the dollar are an often overlooked element of budgeting, but that doesn't make it any less important. Non-profits should plan and even anticipate rising costs for some, if not all, expenses. In particular, you should expect rising costs of healthcare and basic utilities.

Although much less common, deflation has been known to occur in the United States. Deflation effectively increases the buying power of the dollar. However, rather than looking for ways to spend the dollar, view it as an opportunity to save or invest the money that would have otherwise been spent during an inflationary period.

Laws & Regulations

Government is always introducing new laws and new regulations at both the Federal and Local levels. Many of these changes will not impact the organization at all, but others can have a major influence. Usually these influential changes are around reporting requirements, which in turn increase the amount of time required to document and track. When considering this element of the budgeting process, ask at least the following questions:

- Were there any changes in State or Local employment tax laws?
- Were there any changes in Federal employment tax laws?
- Were there any changes in State business or sales tax laws?
- Were there any changes in contractor tax laws?

Resource Availability

The basic concept of supply and demand is extremely relevant to the budgeting process. If supply is not anticipated to keep pace with demand, then not only will prices increase, but it will be harder to obtain the desired resources. This includes not just physical resources, but also human and intangible resources. For example, if the organization is planning a major website overhaul and experts predict a shortage of qualified website designers, then the organization should plan on higher than normal costs for this project. Office space could be another major consideration. If vacancy rates are high, then the organization is in a better position to bargain for lower rates.

Internal Forces

Having now reviewed the major external forces and their impact on the organization, we can move on to evaluating internal forces. There are six internal forces to consider, each of which management has the power to alter. Therefore, it is imperative that management sort through these items before, or at least concurrent with, the budget process. A sound approach is to select two alternatives for each internal force element upon which multiple draft budgets can be generated.

Strategic Plan

Without a plan, or at least a direction, the organization can't hope to create a meaningful budget. A strategy involves a conscious decision regarding guiding principles, such as risk tolerance, organization branding, growth or stagnation, and program delivery. A documented strategic plan that is fully supported by stakeholders is then used to identify what additional key resources might be required and, furthermore, from where the funding could be derived to support resource acquisition. Major shifts in the strategic plan or aggressive plans may require acquisition of major capital resources, like larger office space or new equipment. Decision-makers and planners should regularly answer the following questions:

- In what direction do we want the organization to go?
- Are there opportunities we might take advantage of?
- How can we minimize any potential threats to survival?
- What must be accomplished in order to move in that direction?
- What additional resources will we need and how much will that cost?
- From where will the funding for those additional resources come?

Near-Term Objectives

The organization's SMART objectives are directly translated into dollar figures. Objectives must compliment the strategic plan and be Specific, Measurable, Attainable, Realistic, and Time-bound. For example, an arts organization could have an objective to produce one sold-out event in the first quarter of the year that nets $5,000. This objective meets all the criteria and lays a solid foundation on which to budget. The organization would then identify what specific tasks and resources are required to meet the objective and consequently how much each task would likely cost. The organization now has monetary figures based on realistic and measurable objectives, rather than trying to force the objectives to match numbers pulled out of the air.

Technology

Whether you are an early-adopter or a late-adopter, there always comes a time for replacing equipment and technology. Anticipating that computer crash or, even better, replacing it before it crashes is a responsible way to handle technology. Technology upgrades may also be a component of the strategic plan. For example, if the organization plans to host its own website, it will require obtaining a reliable server.

Technology will also play a surprisingly significant role in the efficiency and effectiveness of the team. If computers are slow and frequently fail, then tasks will take longer and, hence, cost more. Additionally, if the organization accepts credit card payments but processes them manually, the frequency of errors will be greater than with a more automated system.

The organization should also ask itself:

- Is the level of technology consistent with the current and anticipated level of organization and accounting complexity?
- Is our existing technology sufficiently secure from penetration and viruses?
- Does the existing technology support or hinder personnel efficiencies?
- What technical equipment is nearing the end of its expected useful life?
- Are we usually an early adopter or late adopter of technology?

Personnel Capacity

In both a physical sense and mental sense the capacity of the personnel will impact actual monetary outcomes. If staff is “worked to the bone,” there will come a point of diminished efficiency. Conversely, if there is part-time staff willing and able to take on additional responsibility, the organization has capacity for growth.

A secondary consideration is the intellectual and technical competencies of the personnel. Before undertaking drastically new directions or strategies, it might be wise to provide professional training for existing staff and/or plan to bring on new staff.

Reward Structure

Both a highly disciplined reward structure and the complete lack of a reward structure for staff, volunteers, and board will impact financial results. An effective reward structure can enhance efficiency and productivity. Although monetary rewards are less common in nonprofits, a simple bonus structure based on a pre-defined goal can go a long way. Furthermore, non-monetary rewards often have hidden costs, such as valuable time. Whether monetary or not, rewards should not be overlooked, but rather must be a planned element of the entire strategic planning process. The following questions should aid in analyzing reward structure:

- Have we offered rewards in the past? Why or why not?
- What type of reward would be best suited to our organization’s culture?
- If we offer monetary rewards, will it be paid quarterly, annually, or other?
- For what specific objectives will we offer rewards for achieving?
- Who is qualified to participate and receive a reward?

Historical Precedence

This internal force is intentionally at the bottom of the graphic on the first page. It is placed last because it has the lowest relevance to the future when compared to the other forces. Historical information reflects things that have happened and is no guarantee of the future. Nevertheless, trends in historical information are useful as an indicator of the probability of certain future outcomes or occurrences.

Thinking back to inflation, if the cost of health benefits for employees has increased on average 20% per year, it's a good bet that next year will see the same.

Historical precedence is particularly useful when it comes to figuring the timing of certain revenues and expenses on both an accrual and cash basis. An annual liability insurance premium will usually be paid in the same month every year. Or pledge payments from an annual campaign have historically been received two months after. This type of historical information is applicable and very relevant to the budgeting process.

Final Considerations

Budgeting is both science and art and should not be used as the final determining factor of either the organization's success or an individual's success. Rather, the budget is one piece of a larger set of tools and methods for successfully managing an entity. Remember, a budget is not a prediction of the future as much as it is a picture of where the organization wants to go. A budget should be re-evaluated at least once during the year, if not more frequently.

While most organizations are familiar with a static budget, it is not the only flavor at one's disposal. Consider incorporating a flexible budget and/or a rolling budget. A flexible budget automatically adjusts certain figures to be more consistent with actual events. For example, if fewer students enroll in an art class, then fewer supplies will be purchased, so the budget should adjust down the supplies expense to reflect this fact. A rolling budget continuously adds a month or a quarter roughly one year out. The benefit is that it encourages members to always be thinking about long-term outlook and planning.

By

Duane Landon, MBA MPA EA
Financial Services Manager
501 Commons