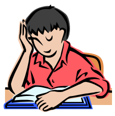
LESSON 7

CREATING A BUDGET

Objectives: The purpose of this lesson is to provide an overview of the budgeting process and the purpose for completing a budget. A sample budgeted Income Statement is provided. Implementation and analysis of the budget is described as well as how to calculate budget variance.

You will develop an understanding of why budgeting is important and how each area of the branch is part of the budgeting process. Topics include:

- Benefits of budgeting
- Who completes the budget?
- The budgeting process
- Implementation and Analysis
- Budget variance



Benefits of Budgeting

A budget is a prediction of the financial condition of an organization for a future time period. Budgets differ from cash flow forecasts in that they consider all items on the Balance Sheet and Income Statement, not just cash items (refer to the Accounting Study Guide - Statement of Changes in Financial Position). A budget provides a plan so that everyone in the organization has a similar vision of where the organization is going during the next time period. The budget projects assets, liabilities and equity as well as revenue and expenses for the future. Generally, budgeted Balance Sheets and Income Statements are produced on an annual basis whereas cash flow forecasts (as described in previous session) are produced on a more frequent basis.

A budget motivates an organization to reach its goals and is a tool for monitoring progress towards those goals. It helps management make decisions about the organization, manage the financial resources of the organization and avoid certain problems before they occur. In addition, when the staff is involved in developing the budget, each employee feels a degree of ownership and is more committed to the success of the organization.

An effective budget should:

- state all of the assumptions
- be understandable and simple
- represent the combined judgment of staff and management
- cover a period for which reliable estimates can be made
- be flexible to permit adjustments

- establish standards of performance
- provide motivation and guide performance
- guide management and staff toward objectives.[1]

Generally, budgets are based on the previous year's (or other time period) results. Ratios can be used to create a budget as long as the period which the ratio is based on is fairly typical of future periods and did not include any extraordinary income/events. Each item on the Balance Sheet and Income Statement must be projected individually taking into account previous results, the internal and external environment and the goals of the organization.

Consider how you are involved in your organization's budgeting process. Do you feel that it is beneficial to you and to the organization? Does it affect your performance?

Who Completes the Budget?

To be effective, budgeting should involve everyone in the organization. Credit officers must determine individually how many loans they will disburse and of what value, to forecast the organization's largest asset – its loan portfolio. They must also determine how many loans which loans will be repaid and when. The majority of the organization's revenue can then be budgeted, based on the loan portfolio. In addition, expenses must be budgeted.

By adding together each credit officers' budgeted portfolio, the branch or organization manager is able to consolidate the branch portfolio and determine the associated expenses. Each area and region is then able to consolidate their branches and provide Head Office with budgeted amounts that can then be consolidated for the organization.

At each step of the way, it is necessary to verify that the information is realistic and created in a consistent manner by all credit officers and branches.

Budgeting Process

Most organizations have specific methods (computer spreadsheets, off-sight planning sessions, etc.) of compiling a budget. This training does not put forth a budgeting model. Rather, it suggests guidelines and processes to create an effective budget.

If it is available, the budget for the previous period (one year for the purposes of this session) should be compared to the actual results of that period and the variances analyzed. Was there a lot of variance? Are there valid reasons for the variances? Did the budget meet the organization's goals?

Next the external environment needs to be analyzed with a focus on competitive and economic information. Relevant competitive information should be based on what other micro-finance organizations, NGOs and banks are doing in the region/country. Economic information should include both the national and local economy, population trends, government legislation and policies.

---

[1] Jerving, Jim. Financial Management for Credit Union Managers and Directors. Madison: The World Council of Credit Unions. 1989.

By analyzing the internal environment, the organization's (or the branch's) strengths and weaknesses can be determined. Looking at the financial picture of each branch and the organization as a whole provides helpful information. Studying the client mix in terms of the number of years as clients and loan maturity, as well as staff requirements at the branch level is also important.

Think of some examples of both external and internal events or policies that would affect the budgeting process. External examples: density and type of financial institutions or other credit providers, types of economic activities financed, cultural factors, market demand, legal environment, inflation/market rates for debt, foreign exchange issues for donor funds. Internal examples: number of staff, communication between staff/branches, quality of staff, flow of information.

After analyzing the external and internal environments, existing policies and results should be reviewed to determine the effectiveness of policies and the need for new or different policies, all of which will affect the budget calculations.

The next step is to develop goals for the upcoming year/period. Generally, goals for the organization will be determined at the Head Office level and should consider both outreach goals and financial goals. In addition, each department or branch should develop goals of their own (in accordance with Head Office goals) and determine how their operations will be affected by these goals.

Studying past trends such as client growth, portfolio growth, delinquency rates, etc., will give an indication of what may occur in the future.

List goals that you would like to achieve for your specific areas. Are these goals realistic? What steps would be necessary to achieve them?

Once the implications of external and internal environmental factors have been determined, and the organization's goals are set, a working budget can be created. This is done by allocating figures to meet the goals and pay for operating expenses.

For example, if one goal is to increase loans outstanding by 5%, then the previous year's portfolio outstanding would be multiplied by 105% to provide the budgeted amount of portfolio outstanding for the upcoming year.[2]

Projected Loan Increase

Total portfolio outstanding at 31 Dec 94	P7,340,000
Projected growth for budget year (5%)	367,000
Budgeted portfolio outstanding for 1995	P7,707,000

Increases or decreases in various line items can be calculated in a similar manner. It is generally helpful to begin by budgeting the portfolio size (asset), which is usually set as a goal of the organization; revenues are then based on the targeted portfolio size. It is then possible to calculate the operating expenses required to reach the goal.

[2] Note that to increase average loans outstanding by 5%, loan *disbursements* will have to increase by more than 5% – depending on the loan term. That is, if loan principal is repaid at 8% to 9% per month, then loan disbursements must increase by twice the amount of the desired increase in portfolio outstanding.

The following steps are suggested for developing a working budget:

Portfolio Budget

- determine the monthly loan disbursement amounts according to the age of the branch and past history
- determine the loan portfolio outstanding for the year taking into account the current and Past Due loans and the portfolio turnover (affected by loan term)
- determine the amount of loan repayment
- determine the revenue on the basis of the loan portfolio

Expense Budget

- estimate all operating expenses for the period
- estimate Loan loss provision required
- estimate financing costs for the period

Once the working budget(s) have been reviewed, revised and finalized, a final budget is developed. Budgeting is an iterative process between Head Office and the branches or departments. Approval of each branch budget is made at a higher level and is used to evaluate the performance of the branch during and at the end of the period.

An example budgeted Income Statement is shown on the following page. A complete budget includes a Balance Sheet but this involves estimating funding requirements (debt or equity) and is beyond the scope of this study guide.

Implementation and Analysis

Implementing the budget is an important component of budgeting. Management must work with staff to make sure that the budget projections become a reality. To be effective, reports against budget must be easily understood and timely. At a minimum, budget reports should be prepared at the end of each quarter. They should also be flexible enough to adapt to the needs of various levels of staff and the board.

Regardless of how carefully a budget is developed, actual figures will differ from those projected. Variances should be explained as they occur.

Budget Variance

Budget variance analysis refers to comparing actual results with those budgeted at a specific period of time. When analyzing budget variances, two additional columns are included in the budget: in the first column, actual figures are reported for each item; the second column shows the difference between budget and actual. This is referred to as the variance and it can be positive or negative. Any significant variances must be explained. If the variance was caused by a non-recurring event, then future budgets need not be adjusted, although the variance must still be explained. If the variance is caused by poor budgeting, then the reasons underlying the mistake should be determined in order to avoid such mistakes in future budgets. If the variance is due to inefficient operations or inadequate staff efforts/workload, then credit policies, staff expectations, staff incentives, etc. should be modified.

SAMPLE BUDGET INCOME STATEMENT

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	TOTAL
Loan Portfolio Outstanding:													(Average)
Current loans	43,000	47,000	50,000	51,000	54,000	57,000	59,000	62,000	64,000	65,000	67,000	70,000	57,400
Past Due loans	13,000	13,000	14,000	14,000	11,000	11,000	9,000	11,500	11,500	12,000	10,000	10,000	11,500
Restructured loans	0	0	0	0	2,000	2,000	2,000	2,000	2,000	2,000	1,000	1,000	1,000
Financial Income:													
Interest on current and past due	575	600	625	630	655	675	690	720	730	735	750	775	8,160
loans	–	–	–	–	–	–	70	–	–	–	–	–	70
Interest on restructured loans	–	–	75	–	–	75	–	–	–	75	–	75	300
Interest on investments	260	260	260	260	260	260	260	260	260	260	250	250	3,100
Loan fees/service charges													
Total Financial Income	835	860	960	890	915	1,010	1,020	980	990	1,070	1,000	1,100	11,630
Financial Costs:													
Interest on debt	170	170	170	170	170	170	170	170	170	170	150	150	2,000
Interest paid on deposits	0	0	0	0	0	0	0	0	0	0	0	0	0
Total Financial Costs	170	170	170	170	170	170	170	170	170	170	150	150	2,000
Gross Financial Margin	665	690	790	720	745	840	850	810	820	900	850	950	9,630
Provision for Loan Losses	–	–	–	–	–	–	–	–	–	–	–	(1,400)	(1,400)
Net Financial Margin	665	690	790	720	745	840	850	810	820	900	850	(450)	8,230
Operating Expenses													
Salaries and benefits	283	283	283	283	283	283	283	283	283	283	283	287	3,400
Administration expenses	60	60	60	60	60	160	560	60	60	140	70	270	1,620
Travel and transportation	110	110	110	110	110	110	110	110	110	110	110	120	1,330
Occupancy expense	120	120	120	120	120	120	120	120	120	120	120	120	1,440
Office Expenses	20	20	20	20	20	20	20	22	22	22	22	22	250
Other	0	0	0	0	0	0	0	0	0	0	0	0	0
Total Operating Expenses	593	593	593	593	593	693	1,093	595	595	675	605	819	8,040
Net Income From Operations	72	97	197	127	152	147	(243)	215	225	225	245	(1,269)	190
Grant Revenue for Credit Operations	–	–	–	–	–	–	–	–	–	–	–	–	–
Excess of Income over Expenses	72	97	197	127	152	147	(243)	215	225	225	245	(1,269)	190

Complete the following "Budget" Exercises.

Creating a Budget

EXERCISES

1. What are the benefits of budgeting?

2. What are the characteristics of an effective budget?

3. Describe the budgeting process.

4. How is the budget implemented and analyzed?

5. Using the following assumptions, prepare a budget for the year ending 1995.

- current portfolio and income on current loans increase by 15%
- no grants for operations
- interest on debt increases by 200
- write off loans for 500
- restructured loans and interest on restructured loans double
- past due portfolio remains the same
- interest on investments decreased by 500 (due to lower interest rates)
- no change in late fees
- all operating expenses increase by 10%
- Loan loss reserve increase by 2,000
- loan fees increase by 7.5%

Compare the budget with actual figures (from the Income Statement in the Sample Account Analysis) and calculate the variance, stating whether it is a positive or a negative variance.

	Actual 1994	Budget 1995	Actual 1995	Variance	Explanation
Loans Outstanding					
Current	50,000		66,000		
Past-Due	19,500		17,000		
Restructured	500		1,000		
Total Loans Outstanding	70,000		84,000		
Financial Income					
Interest on Current & Past Due Loans	12,000		15,400		
Interest on Restructured Loans	50		100		
Interest on Investments	1,500		500		
Loan Fees/Service Charges	5,000		5,300		
Late fees on loans	300		200		
Total Financial Income	18,850		21,500		
Financial Costs					
Interest on debt	3,500		3,700		
Interest paid on deposits	0		0		
Total Financial Costs	3,500		3,700		
GROSS FINANCIAL MARGIN	15,350		17,800		
Provision for loan losses	3,000		2,500		
NET FINANCIAL MARGIN	12,350		15,300		
Operating Expenses					
Salaries and benefits	5,000		6,000		
Administrative expenses	2,500		2,600		
Occupancy expense	2,500		2,500		
Travel	2,500		2,500		
Depreciation	300		400		
Other	300		300		
Total Operating Expenses	13,100		14,300		
NET INCOME FROM OPERATIONS	(750)		1,000		
Grant Revenue for Operations	950		0		
Excess Of Income Over Expenses	200		1,000		