

A Trustee's Guide to the Annual Operating Budget Process

by James R. Pugh ¹

Most schools are now well into their budget development season. In my experience, the board of trustees often arrives at the end of the process with the feeling it has not had sufficient time to consider the information and issues that come together in this annual exercise. This year, with continuing financial stress in the economy, it is especially important to get it right. I would like to share a few thoughts about the process and how heads and trustees can be satisfied with the end product.

Each independent school has its own distinct style and calendar. This article will look at some of the elements they have in common. In general, the larger the institution, the more work goes into the budget.

Why is the annual budget so important?

The operating budget is the authority extended by the governing body to expend money. Without a budget in place, the administration and the school's departments will lack spending authority and a spending plan for the school's goals and objectives for the year.

For the trustees, the budget is a way to prioritize the allocation of the school's financial resources. It goes without saying this should be in alignment with the school's mission.

Stage 1: Pulling Together the Full Range of School Activity

How does the budget process start?

A tremendous amount of work goes into the budget before it is shared with the board. At an early stage in the process, faculty and staff have a voice in the operating expenses of their respective areas. Their participation encourages buy-in to the greater mission of the institution.

The process generally starts with the business officer or the division head sending budget request forms to department chairs, who after meeting with their faculty to discuss goals, needs, and resources, prepare a draft budget.

The departments vary in size and all are important. Most academic departments have relatively small budgets that include non-personnel items such as supplies, equipment, and professional development. Math and English, for example, may have an annual budget of several thousand dollars. Administrative offices such as admission or

advancement will have much larger budgets. Buildings and grounds, depending on the size of the physical plant, may be the largest as it oversees a wide scope of operations: utilities, repairs, preventive maintenance, custodial, security, waste management, and the like.

Does the board have a role in the early stage of the budget process?

Yes. As soon as the board has reviewed the current year's budget in light of the academic year's opening day enrollment, it is time to begin thinking about the upcoming fiscal year. The finance committee should "tip off" the administration as to the major budget parameters it anticipates. Such parameters include enrollment, pay rates, staffing level, endowment draw, annual giving, capital projects, and possible transfers to the plant reserve (provision for plant replacement, renewal and special maintenance or PPRRSM). These initial numbers are not final, but the early direction helps the administration to start off on the right track.

What budgets does the business office directly oversee?

Items such as protective and liability insurance, legal services, the external audit, benefits, and debt service may be overseen by the business officer. It is advisable for a member of the finance committee to be familiar with these areas as well.

Who oversees the "general institutional" budget lines?

This diverse category may include parent and alumni events and associations, trustee and employee events, graduation, outside speakers, and more. They add up. Oversight of these activities varies among schools. It is easier to ask questions if one understands the lines of responsibility.

Stage 2: The Administrative Budget

What happens to the department requests?

At some point, all of the requests come to the business officer to be organized in a massive spreadsheet. The requests invariably outstrip the resources that will be available to fund them. It is time for prioritization. The head of school often asks members of the leadership team to discuss the requests and weigh in with recommendations. Which projects do we **need** to do? Which do we **wish** to do if funding is available? Which requests are unrealistic or unnecessary? The result is an **administrative budget**. I think of this as the "first cut" of the budget.

Are the departments off the hook once they have submitted their requests?

No. The administration (the head of school, business officer, or division director) is likely to ask for supplemental information or pose questions that challenge department assumptions. Can we get another year out of the old digital projectors? What if we reduce the number of teachers who attend an annual school conference? Why is the science department's budget for chemicals and replacement equipment up 50 percent next year? Why do we need a new truck? This back-and-forth is a regular part of the process.

What communication is there with the finance committee during this phase of the budget work?

The head of school or chief business officer should regularly give the finance committee chair a preview of emerging budget issues.

Stage 3: The Administrative Budget Goes to the Finance Committee

How much information should the finance committee receive?

The budget should be presented on one page. It should also be presented in multi-page detail. Some board members like to start with the bottom line and then drill down to the individual department lines. Some like to start with the detail and work back to the bottom line. The quality of discussion within the finance committee is best served if both approaches are possible.

What supportive information should be provided?

- a) *History*. Two or three years of budget history are good for perspective.
- b) *Sensitivity Analysis*. There are a dozen key levers in the budget. Putting a price tag on them helps to remind everyone about the connectedness of the budget's many parts. What is the revenue gain of adding \$100 to tuition? What is the revenue gain of increasing the endowment draw by 25 basis points? What is the added expense of increasing salaries and wages by 1 percent? Each topic will be discussed on its individual merits, but in the end, they will be considered as a whole.
- c) *Available Comparison Data of Peer Schools and Competitors*. This may include enrollment, tuition, financial aid, and expense per student. Some schools share this information. Much of this comparative data is available on NAIS's StatsOnline (www.nais.org).
- d) *Projected Budgets for the Next Three to Five Years*. This is imperative. The assumptions underlying the projections should be stated: enrollment, tuition, salary pool, financial aid, benefits, and staffing changes. This projection exercise can spot financial challenges a year or two before they arrive. It gives the finance committee a lens to consider the perennial question: "Is the school moving **towards** 'financial equilibrium' or **away** from it?" The world doesn't stand still; neither should schools.
- e) *The Financial Section of the Five-year Strategic Plan*. It is worth a look to see if the 2010-11 budget is in sync with the board-approved strategic plan.

If there is a budget crunch, why don't we just trim the "variable costs?"

This is a good question. The problem is that our schools have hardly any variable costs.

Salaries, wages and benefits generally make up 60-70 percent of expenses. Other operating expenses are equally "fixed". Buildings need to be cleaned, heated, and repaired. The campus needs to look sharp for major school events. The website needs to be comprehensive and current. Any variable costs are few and far between.

Most schools are good at finding savings. For example, many have installed sensor-activated light switches to offset electric rate increases. An alert administration continually finds such expense trims. At some point, however, these won't be enough to balance the budget. Some structural adjustment is needed.

My work with groups of schools suggests the biggest cost driver over the last decade has been on the administrative side of the school operation – not in education or plant. When budget pressures dictate a hard look at expenditures, a school might start by examining the administrative positions and student support services that have been added in recent years. Is each position essential? How did the school handle this work before the addition?

At some point, a school may need to turn the notion of fixed costs on its head. The new reference point will be: “There is no such thing as a fixed cost.” Every program and position should be on the table for the budget discussion.

Is it ever too late for the finance committee to pose questions to the administration?

Of course not. The budget is an iterative process at each of its levels. The finance committee should work on the budget until it is comfortable that the budget is realistic and workable. The committee should digest the details so the full board can discuss the bigger issues of priorities and strategy.

Checklist – Key Steps in the Budget Process

- √ **Beginning of the budget process.** The finance committee sets the parameters for the administration to work within.
- √ **The business office collects division and department requests.** The finance committee chair discusses general institutional budgets (such as protective insurance, audit, legal, debt service) with the chief business officer.
- √ **The finance committee receives the “administrative budget.”** The committee discusses the budget in the context of several years of budget history, sensitivity analysis, comparison data with other schools, three to five years of future budgets, and the school's strategic plan.
- √ **The board of trustees votes next year's tuition, financial aid pool, and the employee salary pool.** The trustees set these items at an early date, confident that the school is within striking distance of a balanced budget.
- √ **The board of trustees adopts the formal balanced operating budget.** The final budget is a realistic plan, with realistic assumptions about the revenue and expense sides of the ledger.

Stage 4: Full Board Discussion and Votes on the Budget

Does the January/February budget need to be final?

Generally, 90 percent of the school's budget work is accomplished by January. With some schools, this is accomplished earlier in the fall. Enough of the budget work needs to be in place so the board can make decisions about:

1. *tuition*
2. *the financial aid pool*
3. *the salary pool (i.e., salary increases)*

The administration needs to know these well in advance of the next school year so it can send out enrollment agreements, financial aid offers, and employment offers to faculty during the late winter or early spring.

Some schools adopt the final budget early in the calendar year. Many wait until May or June when fuller information is known about enrollment, annual giving, utilities, and insurance rates. Some schools wait until September or October (after opening enrollment is known) to adopt the final operating budget. A later adoption date typically provides the most accurate budget.

What contingency should be built into the budget?

Some schools routinely budget a 2-3 percent surplus. This is great if a surplus can be achieved without sacrificing important programs. Any surplus at FYE can be applied to the ever-needy capital replacement fund or transferred to the quasi-endowment.

Most schools can't find their way to a budgeted surplus. Yet if you look closely enough at the numbers, you will find contingencies built into individual budget lines. These lines include the cost and usage of fuel oil, the cost of food, facility rental income, water and sewer rates to be set by the town in November, interest on variable-rate debt, health insurance premiums that renew in January, the undetermined salary of the substitute for a teacher who is going out on maternity leave in the winter, and so forth. There are scores of these estimates in the budget.

Each estimate should be conservative but not overly so. If all are budgeted as a worst-case scenario, the school will likely wind up with a surplus – at the expense of either its core programs or a too-high tuition. If all of the estimates are best-case, they will likely net out *in toto* to a sizeable deficit. Virtually all budget estimates – individually – will be wrong. Cumulatively, they should balance out. The school needs a cushion, but not too much of one. In the year ahead, the business office will monitor how the budget is doing against these educated guesses.

Another form of contingency is to start the year with a few cards in the back pocket. These can be played in case an unforeseen problem crops up. Can daily cleaning be reduced to every-other-day “skip cleaning”? Can the number of field trips be reduced? Can the student literary magazine come out in digital form rather than as a glossy

booklet? Can tomatoes be dropped from the salad bar for the winter months? Can the school do without an administrative position that it recently added?

What if it is a “stubborn budget” that simply won’t balance?

Except in extraordinary circumstances, the board will insist upon a balanced budget. Sometimes, however, revenues and expenses firmly resist coming into line. If “budget deadlock” happens, the administration may then need to present a list of possible expense reductions with a *pain/risk analysis* of each. The choices will be difficult, so the quality of dialogue between the board and the administration is key.

Stage 5 – The Final Budget is Adopted

When should the “final” budget be revised?

Most independent schools depend on enrollment for the bulk of their revenues. It remains to be seen how student demand will hold up in this economic climate. This will vary from region to region.

The loss of five or 10 students can make a huge difference for a school, given its committed costs of operation. Some schools are preparing for this possibility by seeking legal advice on how to make employment offers to teachers and staff that are contingent upon enrollment. This is hardly the kind of reassurance the employees seek, but it is going to be a fact of life in some schools. A school’s primary obligation is to parents and students. The faculty needs to be reassured that the administration is doing and will do all it can to preserve (and enhance) their jobs, but there may be factors beyond the administration’s control that make this impossible.

The budget should be revised any time the projected deficit threatens the long-term viability of the educational program. The capacity of an institution to absorb a one-year or multi-year deficit will vary according to its resources, cost structure, and obligations to banks and bond holders. It is hoped that when the impending deficit surfaces, it will not come as a total surprise. It is much easier to handle a problem if it has been considered in advance – during budget construction.

When does the school start working on the next budget?

There is no rest for the weary. The operating budget is a continual process of monitoring, reporting, discussing, and designing.

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