Historically, especially in what now is referred to as the nonprofit sector, most activities were managed on a cash basis. Activities and service levels varied based on the presence or absence of adequate resources. By the late 1800s, public administration had evolved to the point where revenues were anticipated; this information was then used to develop expenditure plans. Budgets provided a mechanism for dealing with both known and anticipated financial problems in an organized manner. Even before adopting full accrual accounting—which measures revenues when earned (rather than when cash is collected) and expenses when incurred (rather than when paid)—budgets proved valuable in eliminating the uncertainty that comes with pure cash accounting. Given that needs always exceeded resources, the relatively recent advent of planning and budgeting helped institutions set priorities.

Why Bother with Budgeting?

Even more than many other nonprofit institutions, colleges and universities have a complex operating environment. The variety of revenue sources, the compliance requirements to which they are subject, and the nature of the restrictions attached to many of their resources make both planning and budget development challenging propositions. Still, without an effective budget process, managing a college or university from a financial perspective would be nothing less than chaos. An effective planning process leading to a clearly articulated budget provides a means of tracking revenues and expenses so that resources can be used most effectively to meet the institution’s goals while still complying with external constraints.

Budgeting also enables an institution to highlight the costs of particular activities and their respective claims on resources. This exercise is especially valuable for activities supported with unrestricted resources, where there may not be a direct link between the sources of revenue allocated to the activity and the activity’s expenses. It may be less necessary for some activities supported with restricted resources: If the revenues are reduced or eliminated, it usually is obvious that the activity will experience operational cutbacks or be terminated.

On the other hand, when unrestricted resources are expected to increase, the institution has an opportunity to increase the resources allocated to particular activities, undertake new activities, or simply increase amounts reserved for future use. These decisions become more evident when articulated through the budget. And they become easier to make and implement if they are guided by an effective planning process.
In short, a budget is a map that guides an institution on its journey to carry out its mission. For nearly every institution, the mission includes multiple elements, such as instruction, research, and public service. Some institutions have an additional mission element—patient care. Regardless of the specific elements of an institution’s mission, an effective budget will address them all.

You can learn a great deal about an institution merely by reviewing the budget—especially if prior-year budget information is available for comparison. Comparing the projected revenues and anticipated expenses provides clues about the institution’s priorities. Even a cursory review will suggest the relative importance of the mission components and will detail what revenues are anticipated and how they will be deployed in carrying out the mission.

A Range of Roles

Budgets take many forms but usually include at least two components: quantitative and narrative information. The quantitative component details the numbers that indicate the expected revenue—by category and by relative amount. It also provides the basic information about how funds will be expended. Some quantitative formats are highly aggregated, showing just the major categories of revenues (for example, tuition or governmental appropriations) and expenses (for example, instruction and public service or compensation and utilities). Others are detailed, showing individual expense categories for specific institutional units.

The narrative component provides additional information about the numbers that appear in the quantitative budget. Depending on the approach taken, the narrative may highlight the specific priorities addressed, the assumptions used in developing the budget, and the constraints that affect the numbers in the budget. It also may refer to specific goals and objectives for the institution as well as its individual units.

Budgets serve many purposes and have various roles. Specifically, the budget is:

The financial representation of the institution’s plans—both strategic and operational. It is developed through iterative processes and, once finalized, presents the results of a multitude of resource allocation decisions. These decisions are not made in a vacuum. They reflect advice and guidance from the board, discussions among senior managers, and—in the most effective settings—dialogues involving the institution’s various stakeholders.

Unless driven by the institution’s plans, the budget will not achieve the ultimate purpose of intentionally moving the institution toward enhanced service and improved quality. Some people mistakenly believe that the budget is the plan. But if that’s the case, the budget process represents constrained thinking because it is overly influenced by the previous budget. Starting the budget process with effective planning that identifies institutional priorities in light of current realities and past financial decisions is one step toward ensuring that resources are deployed most effectively.

A forecast of the institution’s financial picture at a future time. Assuming that a budget covers an annual operating cycle that coincides with the institution’s fiscal year, the institution can prepare pro forma financial statements that assume all revenues and expenses will materialize as predicted. These pro forma statements depict the institution’s expected financial condition at the end of the cycle. If reasonably accurate in its predictions, the institution will know what to expect. This effort also can influence the development of the budget. Performing a “what if” analysis can help avoid excessive spending that would adversely affect the institution’s financial health.

Financial ratio analysis (see Chapter Six) can be used to measure the financial health of an institution. By projecting the results of the budgeted operating and capital activity—and making assumptions about investment performance—the institution can project its financial health at the end of the cycle. Most likely, the actual results will vary because of unforeseen factors and the unpredictability of financial markets. Nevertheless, operational results typically have the greatest impact on an institution’s financial health. Therefore, preparing pro forma financial statements based on budgets can be beneficial to an institution that has established a goal of achieving certain financial objectives along with its programmatic objectives.

An indicator of risk tolerance. Assumptions and predictions made throughout the planning and budget development processes cover items as critical as the number of expected entering freshmen and transfer students and as mundane as the expected increase in elevator maintenance fees. Some decisions are imposed on the institution, such as increased utilities costs, while others—such as faculty salary increases—are imposed by the institution. The specific decisions and their impact on the institution’s financial health indicate the level of risk the institution can tolerate.
The greater the risk tolerance, the smaller the contingency built into the budget. Institutions with a relatively higher tolerance for risk budget revenues aggressively and allocate most resources for expenses (including appropriate additions to reserves for future use, such as facilities maintenance). On the other hand, institutions that are less comfortable with risk are more likely to budget revenues conservatively and include contingency amounts to address revenue shortfalls or expense overruns.

Regardless of the institution’s tolerance for risk, it should allocate a portion of the budget to address contingencies. This can be a mix of recurring and one-time reserves that can be used in response to unanticipated opportunities or challenges.

A political instrument. To create the budget, administrators from various units strike bargains and make trade-offs. Throughout the process, many people seek to exert their leadership to influence the ultimate distribution of resources. The final outcome reflects a series of negotiations about which activities should be funded and at what levels.

Often, multiple budget cycles overlap, making it common for negotiations in one cycle to influence other cycles. Although these negotiations rarely result in complete satisfaction for the parties involved, the process is worthwhile. The negotiations provide the opportunity to communicate needs for services and the resources required to provide them. This process can lead to a better understanding of other activities competing for the same scarce resources. Care is needed though because negotiations can be counterproductive if not properly managed. It is important that the process afford each perspective the opportunity to be heard and to receive feedback about the rationale for final decisions in a transparent manner.

Prelude to a Budget

In well-managed institutions, the budget is a manifestation of the institution’s plans and reflects the relative priorities assigned to different activities. It also takes into consideration all constituents’ needs and interests. Because planning must precede budget development, many key decisions already have been made before the budget cycle begins.

Planning is not about choosing between good and bad ideas. It’s about choosing between good and better ideas. Both the planning process and the budget process should have the same ultimate objective: the most effective deployment of resources to support the institution’s overall vision and the priorities that will lead to attaining that vision.

That’s why an institution should decide its priorities before beginning the budget process in earnest. Individual allocation decisions should grow from the decisions made throughout the planning process. Unfortunately, too few higher education institutions use effective planning mechanisms. And many of those that engage in planning do not use it to intentionally guide the resource allocation process.

In too many instances, institutions rely excessively on incremental budgeting—adjusting the prior year’s budget by a fixed percentage to address changes in available resources. While reasonable for addressing portions of the budget, this approach is often used to excess, which leaves the institution unable to achieve enhanced results, build on areas of identified strength, or successfully pursue its mission and attain its vision.

Purley incremental approaches assume that the way resources currently are deployed is the most effective distribution, that all units have approximately equal needs for additional resources, and that maintaining the status quo is in the institution’s best interests. Incremental processes do not lead to success because it is highly unlikely that the current budget—the starting point—is allocated in the most optimal manner. Activities that might flourish with increased resources remain underfunded, while others that may have outlived their usefulness or value to the institution continue to consume resources.

Two factors may help explain the continued popularity of incremental approaches—despite the fact that regional accreditation agencies identify the linkage of resource allocation to planning as evidence of institutional effectiveness. First, incremental budgeting is deemed to be fair: All units receive the same relative percentage of increased resources (or reductions in times of contraction). Second, it is efficient because it provides a starting point and a fixed percentage for adjustments.

The presumed fairness and efficiency, however, come at the expense of effectiveness. A system that perpetuates embedded inequities cannot be deemed fair. Instead, high-performing units should be rewarded with increased resources and spared from cuts. Similarly, activities with the greatest potential to contribute to—or enhance—the institution’s success should receive relatively more resources than units that do not contribute to institutional success or otherwise underperform relative to others within the institution.

The bottom line is that incremental budgeting is efficient, but not necessarily effective, because it ignores the results of planning—which should have identified priority areas. Without question, the most successful approach to budgeting starts with an effective plan—one developed with extensive input from all institutional stakeholders—and develops the budget based on the decisions reflected in the plan.
Types of Budgets

At the highest level, budgets focus on the resources higher education needs for programmatic success: dollars, positions, space, technology, and equipment. Most budgets focus on dollars, because money is the easiest resource to measure and monitor. But budgets also focus on resource allocation decisions. For example, the number of faculty positions is a resource that is estimated based on needs and objectives. For example, the number of faculty positions (or lines) assigned to a given unit translates into salaries and benefits—represented by dollars—for those positions. In turn, space, technology, and equipment will be affected by decisions involving positions.

Higher education institutions use different budgets for a variety of purposes. As its name suggests, the operating budget identifies all revenues and other resources available to support operations—both those that result from various service efforts (for example, tuition and patient charges) and those derived from other sources (for example, governmental appropriations and gifts). It addresses the various elements of the institution’s mission (for example, instruction and research) and also focuses on supporting and ancillary activities, such as libraries and intercollegiate athletics.

Operating revenues either finance the current expenses or contribute to institutional reserves—a form of savings. The vast majority of revenues received during a given period will be expended on operations and related activities during that period. Any remaining unexpended resources will be added to reserves—resources set aside for specific purposes, typically for use in the future. In some cases, however, reserves merely serve as a cushion against future financial problems.

In addition to revenues and reserves, operating budgets present the day-to-day expenses incurred by the institution as it carries out its mission. Colleges and universities incur a wide variety of expenses. Some, such as salaries and wages, make up a significant percentage of the budget. Others may be relatively small and vary significantly based on the character of the institution. For instance, maintenance costs for residence halls typically do not represent a significant expense for community colleges.

Expenses in an operating budget may be displayed in either of two broad categories: natural classification or functional classification (sometimes called programmatic classification). Natural classification refers to expenses identified by type rather than purpose, such as salaries, benefits, travel, and supplies. Though valuable for many purposes, a budget prepared using the natural classification approach provides little information about the activities being conducted. For instance, the natural classification budget for a consulting firm or a health care organization might look very similar to one prepared for a research institution because both entities are labor-intensive.

A budget by functional category would be more valuable as an aid to understanding what is taking place.

Functional classification organizes expenses by the nature of the activity the expense supports. Examples of functional categories for a college or university include instruction, public service, and academic support. The instruction function includes various natural-class expenses, such as salaries, employee benefits, supplies, and travel. Similar types of expenses would be incurred in the other functional categories.

A matrix displaying natural-class expenses in functional categories is a useful representation of an operating budget’s expense side. It indicates the relative investments by functional category and the proportional amount of types of expenses incurred to achieve the multiple programmatic objectives.
residence hall systems typically rely on borrowed funds to finance new construction. It is a fairly standard requirement of bond covenants that a certain portion of annual system revenues be set aside for facilities maintenance, such as carpet replacement, painting, and roof repairs. These funds are maintained in a reserve and invested until they are needed.

Borrowed funds are either short-term construction loans or long-term bonds that finance the acquisition or construction costs for new facilities, major equipment, or infrastructure upgrades or additions. The long-term debt serves the same purpose as a home mortgage for an individual. Colleges and universities frequently issue tax-exempt bonds to fund capital expansion. For some public institutions, the state issues the bonds or provides the resources needed to repay the bonds as they come due.

Many institutions that issue their own debt have established complex financing arrangements to support their capital expansion programs. These usually are supported by board-approved debt plans. Variable-rate debt is a staple among many financing choices to obtain resources needed for longer periods. A number of institutions have relied on various forms of short-term debt to finance construction projects until the institution is ready to convert the obligation to long-term debt.

Internal banking arrangements have become popular in recent years. With an internal bank, the institution issues long-term debt and redistributes the proceeds as needed throughout the institution. The various units receiving the proceeds are then assessed principal and interest charges to generate the resources needed to compensate and repay the bondholders who purchased the institution’s long-term debt.

Expenditures appearing in a capital budget include construction costs that will be capitalized as well as other costs that—because they cannot be capitalized—will be recognized as expenses during the year they are incurred. (Capitalized costs relate to an asset that will provide benefits beyond one year.)

Both operating and capital budgets can be developed for the institution as a whole or for subsets of the institution. For instance, a capital budget might apply to an individual project, such as construction of a particular building, or it can address all currently approved capital projects for a given period. Similarly, operating budgets can address the complete range of activities for the institution, or they can simply cover activities within a department or a single programmatic area, such as instruction or student affairs.

Several variations of budgets address specific situations. For instance, some institutions prepare special budgets focused only on restricted funds. Restricted budgets indicate resources provided by external parties that carry stipulations about how they must be expended. Examples include gifts provided to acquire library books and income from an endowment established to fund scholarships for undergraduate students from a particular locale. Another example is a grant from a governmental entity that must be expended for specific purposes.

Special-purpose budgets must be clearly labeled and explained to avoid confusion about what they represent.

Subject to Revision

Even the best of planning processes simply cannot anticipate some events and developments, so all budgets are subject to revision. In fact, the ink on the latest budget document probably will not be dry before circumstances dictate that adjustments be made.

In most cases, the budget for a given cycle begins with the budget from the current or most recently completed cycle. Presumably, the starting point reflects the cumulative impact of all revisions to the previous budget other than temporary situations. Even so, the budget will continue to change over time. That’s why the budget process and the budget itself must be flexible enough to respond to these changes (see Chapter Ten).

Apart from the unpredictability of some expense categories, revenues can vary widely from one year to the next. All institutions have uncertainty regarding the amount of revenue that some sources will generate (for example, investment income). Enrollment unpredictability can be an even greater concern.

For a tuition-dependent institution—one in which 85 percent or more of the revenue comes from tuition and required fees—a relatively small decrease in enrollment can substantially affect the pool of available resources. And this can happen without materially altering the level of expenses that will be incurred. For example, when the freshman class entering a small high-priced institution falls a few dozen students short of the number budgeted, the impact on revenues can approach a half-million dollars. Yet those students may be spread throughout the curriculum in such a way that the same number of faculty will be needed. In this scenario, the reduced enrollment may not bring any cost savings. This is one factor that encourages institutions to diversify their revenue stream.

Different institutions address the unpredictability of revenues in different ways. For institutions that have budgeted revenues conservatively, positive net financial results may lead to increased allocations of resources for use in the current period. Similarly, institutions that include expense contingencies in the budget periodically will make adjustments to reallocate available resources from the contingency line to the expense category that has experienced the cost overrun. This enables the institution to properly reflect its utilization of resources. In contrast, charging expenses directly to the con-
tingency budget will understate the expense category that experienced the overrun. Moreover, if the situation is likely to continue, the starting point for the subsequent budget will not provide a true picture of resource needs.

The number of budget adjustments tends to be lower for conservative institutions compared to those that budget more aggressively. Aggressive budgeters often need to make more adjustments because they are more likely to experience revenue shortfalls and expense overruns in specific categories. With luck, the net impact of the shortfalls and overruns will not create an overall deficit situation, but it is an increased possibility for institutions that rely on aggressive budget assumptions.

Various economic, political, and regulatory developments influence an institution’s budget. Most are beyond the control of individual institutions or even the national higher education community. Accordingly, budgeters must anticipate changes in economic and political conditions that may affect the amount of revenues available and, of equal importance, the expenses the institution may have to bear. Unless an institution’s budget can withstand the pressures created by external forces, its survival may be in jeopardy.

Beginning in the 1990s, economic changes have significantly affected institutions of higher education. In many respects, a sea change in the nation’s support for higher education has accompanied the economic turmoil. Higher education no longer enjoys the high ranking on national, state, and local societal agendas that it once did. Other sectors now capture resources previously directed to higher education, especially by governments. Whether the focus is instead on security, K-12 education, health care, or general social service programs, higher education no longer is viewed as a top priority. Part of this shift stems from a change in perception. Instead of viewing higher education as a public good, many now see it as a private benefit.

In today’s environment, higher education must defend itself continuously against criticism from numerous quarters. In years past, it was enough to highlight the economic value of a college education or point to the discoveries growing out of campus-based research. Such arguments no longer sway a nation that no longer focuses on an ability to pay. The issue has shifted to a willingness to pay. As college prices have escalated—at rates greater than the Consumer Price Index (CPI) in most years—both the federal government and the general population have questioned whether higher education is being managed effectively.

As of 2012, higher education was coming off the worst economic period since the Depression. Although inflation has been held in check, campuses still are experiencing cost increases in critical areas. At the same time, various revenue sources are depressed, with nothing to suggest that things will turn around in the short run. In fact, even prestigious institutions have suspended programs, eliminated positions, or resorted to other cost-cutting measures that have dramatic effects on program delivery. A climate like this requires careful examination of external factors.

The Political Climate

Higher education leaders have plenty of issues to keep them awake at night, with the U.S. Congress often providing the impetus. In recent years, for example, congressional (or federal agency) initiatives have focused on higher

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**Key Points**

- A budget is a map, expressed in financial terms, guiding an institution on a journey as it carries out its mission. A budget is not a plan; it is a product of the planning process.
- Budgeting is a form of resource allocation. Effective institutions integrate resource allocation with planning and assessment. Plans determine what will be done, while budgets dictate the level of resources to be deployed in executing the plans.
- Operating budgets provide details on anticipated revenues and on investments needed to carry out the institution’s day-to-day activities. A capital budget provides financial details on the institution’s short-term and long-term plans related to physical facilities and infrastructure.