

# Briefing Paper

## Preparing Budgets

### August 2010

#### Introduction

This briefing paper looks at the preparation of budgets. It considers what budgets are and looks at Cost Centres, Subjective Analysis, Profiling and Incremental and Zero Based Budgets.

#### What are Budgets?

In 1991, the Chartered Institute of Management Accountants defined a budget as:

*"A plan expressed in money. It is prepared and approved prior to the budget period and may show income, expenditure, and the capital to be employed. It may be drawn up showing incremental effects on former budgeted or actual figures, or be compiled by zero-based budgeting".*

Another definition, perhaps more applicable to the Public Sector was provided by Henley et al in 1992 as:

*"Budgeting is a process of measuring and converting plans for the use of real (that is, physical resources) into financial values. It is the classic problem of how to add together quantities of apples and oranges into a meaningful economic measurement, the only practical way for everyday use is to express their economic values in terms of monetary costs and revenues. Through the process of budgeting the finance function provides the essential link between management planning and management control."*

The key word in that first definition is 'plan'. The budget should be based on Corporate Objectives, Priorities, existing structures and activities. It is though a plan, an estimate, a forecast to be controlled by management throughout the budget period.

That period is typically a single year. Budgets are prepared by organisations for slightly different purposes. For example, in the case of a Local Authority, its primary purpose is to set the Council Tax, and for the Housing Revenue Account to set rents. The tax setting function tends to limit the planning horizon to the short term, that is, one year.

Budgeting for the Medium term is performed by many organisations for time periods between 3 and 5 years. The Capital / Revenue distinction is also important within the Public sector. Capital budgeting is considered below.

The budget is more than just tax-setting, it assists Members to decide priorities and their timing; forecasts the changes in demand for services; allows for the implications of legislative change; matches demand with likely resources; and provides a framework for programming activities by individual services.

The budget also allows management to monitor income and expenditure, and provides legal authority to incur expenditure and collect income.

Any expenditure which is not defined as capital is revenue. The budget exercise starts with the issue of guidance and working papers. With meetings in September or October (assuming a financial year that runs April to March).

The two main methods of budgeting are incremental and zero-based. These are explained below.

Incremental budgeting assumes that the present level of activity is a given and then adjusts for known and estimated changes such as inflation, growth, savings and income generation.

Zero-based Budgeting was introduced by Pyhrr in the Harvard Business Review in 1970. President Carter, while still governor of Georgia in 1973, contracted with Pyhrr to implement the system for the entire executive budget recommendations for the state of Georgia.

This was extended to United States Federal budgeting in 1977. It involved the creation, ranking and use of decision packages to create the budget. In Georgia this involved 11,000 decision packages with 33 pages of instructions and 24 different forms. It was estimated that if the Governor spent four hours a day for two months reading these he could spend one minute on each.

It is usually seen as a useful approach for limited areas of the budget. In a form it is used for Employee budgets in that costs of the staff establishment are costed in detail, built up in cost centres and divisions of service. Also for limited areas of service where the underlying structure and method of provision is radically different or new and no previous data exists or is useful.

A usual method of budgeting is thus incremental with a limited version of zero-based in critical areas. Information on contracts, precepts, inflation rates (often various rates for differing elements) is combined with previous actuals, adjusted for known changes in service provision.

The finance department may carry out all budget preparation merely using the service department as a source of information. At the other extreme service departments can do most of the preparation with the finance staff collating the end results. The usual practice tends to fall somewhere between these two with both service managers and the finance department recognised as having important roles to play.

Greater ownership of budgets is considered to apply, and be desirable, where staff in service departments are responsible for the preparation of their own budgets. It should be stressed that under either model of budget preparation certain officers may have responsibilities for particular aspects of the budget, for example, employees, land or buildings, financing charges, contracts and inflation factors.

Although most of the detail discussed has been assumed to refer to setting Local Authority General Fund budgets, the same disciplines apply to budgets of trading services and any 'arms length' operations. Although Local Authority companies, including Arms Length Management Organisations operate under the Companies Acts. The same principles apply to public sector bodies other than local authorities.

Whilst the 'bottom line' comparison of income to expenditure may be of more significance than the budget itself, budgets should still be compiled on the best assumptions known at the time, including trading levels and volumes. Though forecasting such matters is an imprecise science it may still be attempted. Sensitivity analysis, flexing assumptions is often a useful way of exploring levels and volumes.

With centralised budget preparation the budget working papers will usually be completed by finance staff although spending departments will still have to be consulted about certain aspects of their budgets, for example, whether staff vacancies are committed or not ; costs of new developments ; reasons for under/over spending in previous years. Persistent under spending may be treated as savings, and over spending as growth.

When detailed budgets have been prepared there is also likely to be consultation with departments in case any 'fine tuning' is necessary, and even under this system, departments will have the prime responsibilities for suggesting areas for growth and savings.

With decentralised budget preparation the structure of budget working papers may be formulated by the Chief Financial Officer's department, their completion under this system will take place in service departments.

In larger organisations there will often be a formal system of decentralised financial management with individual departments having formally designated financial officers. These staff may be permanently based in divisional offices but maintain functional responsibility to the Chief Financial Officer.

Completion may be carried out either by such officers or by administrative officers within the individual divisions of departments, but under guidance from the centre to ensure uniformity.

The finance department will receive the completed budgets and their role essentially will be to check that the correct principles have been used and then to collate the budgets for presentation to board/elected Members.

In the case of local authorities with responsibility for education services the detailed allocation and management of the local management in schools (Local Management of Schools in England, devolved management of schools in Scotland) is likely to be carried out within the education department.

Even under a decentralised system, the finance department is likely to maintain responsibility for certain aspects of the detailed budget (for example, financing costs), and will maintain a strategic overview in relation to affordability of spending plans.

It is also likely that finance departments will undertake the bulk of the work required for medium-term financial planning, albeit in consultation with spending departments, even under a decentralised system.

Where the line managers of a service department are responsible for the control and preparation of their own budgets it can be beneficial to have finance staff readily available in their department. Care must be taken, however, to ensure that this benefit is not offset by the loss of authority wide co-ordination and control of the principles behind budget preparation by the Chief Financial Officer.

## **Cost Centres**

In theory a cost centre can be defined as a method of dividing up costs between departments. Or, that managers are responsible for controlling costs within a cost centre.

Controllability is an issue expanded upon below. It is a source of friction between service managers and the finance department at times. Controllability is a concept associated with shades of grey rather than black and white distinctions. Many costs are more or less controllable. And like Fixed costs, in the long term all costs are controllable, or indeed variable.

Stationery might seem like a controllable cost, down to some minimum level at least. Agency Staff are controllable to a point, but if they are covering gaps in permanent staffing there will be a point at which they cannot be reduced without impacting on services.

Recharges from support services may often be categorised as not controllable. The control laying with the support service not the user. Support service levels can of course be negotiated down (or up) but such adjustments can be time-consuming and expensive.

In practice a cost centre is a place within the accounting structure where transactions, in the shape of income and expenditure (or more strictly receipts and payments) are gathered and summarised.

Cost centre structure is often for Local Authorities based on the Chartered Institute of Public Finance and Accountancy's guidance on the Best Value Accounting Code of Practice (Best Value Accounting Code of Practice). It sets out both the mandatory division of services and the discretionary subdivision. A Local Authority's cost centre structure is likely to be based upon that framework. But as long as the cost centre structure is capable of being worked into the required divisions of service, there is freedom to use a structure that suits the Authority's purposes.

There are similar arrangements for reporting cost centres in other public bodies.

Objective Analysis is a generic accounting term for the Chartered Institute of Public Finance and Accountancy's cost centre structure of divisions of service. An example of the Best Value Accounting Code of Practice's service divisions is given below, distinguishing the mandatory and discretionary divisions of service for what is termed Central Services to the Public. Objective thus means, the "Object" or purpose of the cost centre, for example, what service is being provided.

**Table 2: Central Services to the Public**

<b>Division of Service (Mandatory)</b>	<b>Subdivision of Service (Discretionary)</b>
Local Tax Collection	Council tax collection Council tax benefits administration Council tax discounts Council tax benefits Non-domestic rates collection BID ballot costs Cost of collection and distribution of BID levy
Registration of Births, Deaths and Marriages	
Elections	Registration of electors Conducting elections
Emergency Planning	
Local Land Charges	
General Grants, Bequests and Donations	

Cost centres will be represented within this as part of the accounting code structure, often four to six characters in length. They will usually be created for the various parts of the structure, for example, General Fund Revenue, Housing Revenue Account, Trading Accounts, Suspense and Control Accounts, Balance Sheet and Capital.

Within the accounting structure there will also be summary cost centres. These aggregate lower level cost centres. They can form the basis for different levels of control and reporting. The resulting “tree” or diagram of cost centres is often referred to as the Chart of Accounts.

The accounting structure (depending on the system used) and financial system may also allow more than one structure to operate at one time. This though may come with a heavy maintenance overhead for finance and systems staff.

### **Subjective Analysis**

Subjective Analysis is a generic accounting term for the classification of costs within a cost centre. Such descriptions include Employee costs, Supplies and Services and Transport.

Similarly, the Chartered Institute of Public Finance and Accountancy has (for Local Authorities) issued within the Best Value Accounting Code of Practice a standard subjective analysis. It is recommended but non-mandatory.

## Structure of the Subjective Analysis

4.9.3 There are 10 standard subjective groupings:

- employees
- premises-related expenditure
- transport-related expenditure
- supplies and services
- third party payments
- transfer payments
- support services
- depreciation and impairment losses
- income
- capital financing costs (not included in the 'net cost of services').

Employees includes amongst other things salaries and wages, employer's National Insurance and pension contributions, agency staff, interview expenses and training.

Premises-related costs include energy, rents, rates, water, cleaning and grounds maintenance.

Transport includes the direct costs of repairs and maintenance and running costs, also contract hire, public transport and car allowances.

Supplies and Services is a wide category, including equipment, materials, catering, clothing, printing, communications, computing, Private Finance Initiative and Public and Private Partnerships supplies and services.

Third Party payments are payments to external providers or an internal trading operation.

Transfer Payments are redistributions of income such as benefits and subsidies including Housing Benefit.

Support Services includes internal functions such as Finance, Information and Communications Technology, Human Resources, Legal and Corporate Services.

Depreciation and Impairment losses consist of the writing down of the value of fixed assets including the amortisation of intangible fixed assets or deferred charges.

Income includes government and other grants, sales, fees, rents, interest and recharges.

Capital Financing Costs includes the Corporate Capital Financing costs of the Authority, interest payments and debt management expenses.

## Profiling

Budget profiling is an attempt to match an annual budget to spending patterns during the year. For example, salaries for a fixed establishment tend to be the same every month (unless there is a pay award), so a £120,000 annual budget would have £10,000 allocated to each month. This is a straight-line profile, after the way it would be illustrated graphically.

A snow-clearing budget of £120,000 may have a small amount allocated in September for preparatory work, such as filling grit pods, but the rest would be allocated to winter months.

Budget profiles can be established for every budget head. Some financial systems can cope with dozens. Straight-line, employee profiles that allow for pay-awards part way through a financial year, quarterly profiles, end of year, start of year, weekly – say for a budget head where the spend is driven in such a fashion. Custom profiles, such as the snow-clearing already mentioned can be calculated.

The budget profile at a given point in time is then matched with the actual spend, plus any commitments, to give an accurate comparison of spend to budget. The profiled amount of budget is thus an accurate estimate of the proportion of budget that ought to have been consumed at a given point of the financial year.

Budget profiles can thus add to the accuracy of budgetary control and help managers in forming judgements about variances, whether trends are developing in income and expenditure that require action.

Profiles can be difficult to interpret. A budget for sick pay in a Trading arm can be profiled through the year, it exhibits a winter peak, and the profile is constructed accordingly on past data, which may be flexed for known or anticipated changes. A budget for Leisure income may similarly exhibit a summer peak.

Problems then arise during subsequent periods of budgetary control as month on month variances are compared. Is the underlying budget profile rising or falling? Is the changing variance good news or bad news?

Straight-line profiles have the benefit of simplicity, ease of understanding and comparison. As managers interpret budgetary control information they can concentrate on underlying causes, changes in demand, the factors driving income and expenditure.

Whether the budget profile is simple or complex the same questions have to be asked. Is the actual income or expenditure as expected? Is it complete? Are transactions missing? For example, missing contract payments. A large out-sourced contract for Waste Collection could involve large monthly, or four weekly, payments. If some are late the budgetary control needs to allow for this.

## **Incremental & Zero-based Budgets**

Incremental budgeting assumes that the present level of activity is a given. Then adjusts for known and estimated changes such as inflation, growth, savings and income generation. Incremental budgeting is relatively easy to implement, but it has a number of serious limitations; an assumption that the current methodology and cost structure is the best way, and should be built upon; encouraging people to have expectations of inflationary increases in salary and services, for doing the same things in a changing economy; it encourages departments to spend all of their allocated budget to ensure that there is an increase next year.

Zero-based budgeting originally involved managers identifying alternative methods of performing each activity first, such as evaluating the costs and benefits of making a project or outsourcing it, or centralising versus decentralising operations.

In addition, managers must identify different levels for performing each alternative method of the proposed activity. This means establishing a minimum level of spending, often 75% of the current operating level, and then developing separate decision packages that include the costs and benefits of additional levels of spending for that particular activity.

The different levels allow managers to consider and evaluate a level of spending lower than the current operating level, giving decision-makers the choice of eliminating an activity or the ability to choose from a selection of levels of effort including tradeoffs and shifts in expenditure levels among organisational units.

The decision packages must be ranked in order of importance once they have been created.

This allows each manager to identify priorities, combine decision packages for old and new projects into one ranking, and allows top management to evaluate and compare the needs of individual units or divisions to make funding allocations

## **Participatory Budgeting**

Government is currently interested in Participatory Budgeting where the public are given an opportunity to participate in setting budgets through a range of mechanisms including questionnaires, focus groups and consultation with interest groups.

Many local authorities have experimented with ways of enabling individual citizens to participate in budgetary decisions. In particular, 22 local authorities have taken part in participatory budgeting pilot schemes that completed early in 2008. Some of these schemes have been quite modest but others have managed multi-million pound budgets.

In March 2008, Hazel Blears MP, Secretary of State for Communities and Local Government, issued a draft strategy on participatory budgeting that is intended to increase the public role in determining council and other public sector budgets. One idea is to introduce 'Community Kitties'. Hazel Blears was quoted in 'Public Finance' as saying:

*"Community Kitties do not just lead to better services, they give local people the opportunity to influence the future of the place where they live, generate civic pride and bring our communities together with a common purpose."*

However, Julia Goldsworthy MP, Liberal Democrat spokeswoman on Local Government, was quoted as saying:

*"If Ministers were serious about devolved funding they would release their suffocating grip on local government and give local authorities greater freedom to raise and spend money."*

The government's intention is to examine how citizens could influence the budgets of local authorities, police authorities and community health services.

The White Paper, Communities in Control, Real People, Real Power, put participatory budgeting firmly at the heart of the Government's drive to pass more power to local communities and help reinvigorate local democracy.

On 15th September 2008, Hazel Blears MP, Secretary of State for Communities & Local Government, launched 'The Participatory Budgeting national strategy: Giving more people a say in local spending'.

The strategy sets out how the government will work towards their ambition for participatory budgeting to be used in every local authority area by 2012. The strategy takes account of the consultation on the draft strategy that broadly supported the approach to promote and help facilitate participatory budgeting, rather than prescribe or require it.

The number and range of participatory budgeting activities is picking up momentum. On 15th September 2008, another set of participatory budgeting pilot areas was announced, bringing a total of 34 pilot areas in England, covering authorities in different areas. The government is also encouraging participatory budgeting to be used more widely across public service provision, for example in policing and health.

Communities and Local Government funds the Participatory Budgeting Unit, as the department's key delivery agency, to help promote and develop participatory budgeting and advise community development workers and local authority officials on the development of new projects.

Some local authorities have suggested that they should be allowed to breach limits on Council Tax increases if participatory budgeting exercises demonstrated that local council taxpayers would support this as a way of paying for enhanced services. However, the government has rejected this idea.

## **Conclusions**

Budgets can be analysed in three ways: Objectively through cost centres, subjectively and through profiling. Incremental budgeting is the most common method in the public sector although some use is made of Zero Based Budgeting and some initiatives are taking place in Participatory Budgeting.

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**August 2010**