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Taking the fear out of finance!

Financial Management Essentials

A Handbook for NGOs

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Produced by Terry Lewis for

© Mango (Management Accounting for Non-governmental Organisations)
Chester House, 21-27 George Street, Oxford OX1 2AU
• Phone +44 (0)1865 423818 • Fax +44 (0)1865 423560
• E-mail training@mango.org.uk
• Website: www.mango.org.uk

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Mango is an award-winning UK-based charity which provides financial management training, professional support and free resources for humanitarian and development non-governmental organisations.

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Glossary

Account	A record of monetary transactions, either written into a book designed for the purpose or entered onto a computer file.
Account code	A code for a specific type of transaction. Transactions are given a code which describes what type of income or expenditure they are, eg 5050 Transport costs, 5600 Office rent etc.
Accounting period	A specified period for recording and reporting financial activity for a given time, eg one year or one month.
Accrual	Adjustment made at the end of an accounting period to recognise expenses that have been incurred during the period but for which no invoice has yet been received.
Accumulated funds	Money, or equipment, that we build up year by year as a result of not spending all our income. Often referred to as our Reserves.
Acid test	The ratio achieved by dividing Current Assets (excl. Stocks) by Current Liabilities. It tells us if the organisation has sufficient funds to pay off its debts immediately.
Allocation	The sharing of direct costs between two or more cost centres in proportion to actual or estimated use, eg the costs of using a shared vehicle for project work. Income can also be allocated.
Apportionment	The sharing of indirect costs between two or more cost centres in proportion to the estimated benefit received.
Asset	Any possession or claim on others which is of value to the organisation. See also Fixed Assets and Current Assets.
Audit	A formal check on the accounts by an independent person (auditor).
Audit trail	The ability to follow the course of any reported transaction through an organisation's accounting systems.
Authorisation	This is the process of approval over transactions, normally the decision to purchase or commit expenditure. Authorisation by a budget holder is a way of confirming that spending is in line with budget and is appropriate.
Back donor	The original source of funds, where a grant is channelled through an agency, such as an international NGO, on to an implementing partner. The agency must report back to the original donor to account for the use of the funds by the local partner.
Balance Sheet	A summary of the financial position of an organisation at a particular date, showing the assets owned by the organisation and the liabilities (or debts) owed to others.
Bank book	A register which records all transactions passing through a bank account. Also known as a cashbook or a Cash Analysis Book.

Bank reconciliation	The process of comparing the entries and ending balance in the cashbook with the bank statement, and identifying any differences. It provides an important check on the completeness and accuracy of the cashbook entries.
Budget	A best estimate of the amount of money that an organisation plans to raise and spend for a set purpose over a given period of time.
Budget holder	The individual who holds the authority and has the responsibility for managing, a budget for a specified activity, project, programme, department or organisation.
Burn rate	Expressed as a percentage, the amount of a grant or budget used up so far. Also known as the *Utilisation Ratio*.
Capital expenditure	Expenditure on equipment, property and other fixed assets which will be used to support activities over more than one accounting period.
Capital fund	Accumulated funds and reserves held in the form of equipment and property.
Cashbook	A book or spreadsheet that lists all of the receipts and payments made in to and out of a particular bank or cash account.
Cash reconciliation	Comparing the month end physical cash counted to the expected month end balance in the petty cashbook.
Cashflow	The difference between cash received and cash spent in a period.
Cashflow forecast	A report that shows the expected timing of receipts and payments for the next 3-6 months (or longer).
Chart of accounts	A list of all the accounts codes and cost centre codes that are used in an organisation's accounting system, with a description of each.
Core costs	Central support costs shared by many projects. Also called overheads or indirect costs.
Cost centre	A way of distinguishing between different activities or projects to define where costs are incurred or income is 'earned'. Cost centres are closely linked to the concept of budget-holders.
Creditor	Anyone the organisation owes money to.
Current assets	Cash and other short-term assets in the process of being turned back into cash – eg debtors. They can, in theory, be converted into cash within one year.
Current liabilities	Short-term sources of 'finance' (eg from suppliers, bank overdraft) awaiting payment in the next 12 months.
Current ratio	A measure of liquidity obtained by dividing Current Assets by Current Liabilities. It tells us if the organisation is able to pay off its debts within 12 months.
Debtor	Anyone who owes money to the organisation.

Depreciation	A proportion of the original cost of a fixed asset which is internally charged as an expense to the organisation in the Income & Expenditure Account.
Designated funds	Unrestricted funds which have been accumulated over time and set aside for a particular purpose by the Trustees.
Direct cost	A cost which can be specifically allocated to an activity, department or project.
Donation in kind	Where a grant or contribution to a project is made in the form of goods or services, rather than a cash grant or donation.
Double entry bookkeeping	The method of recording financial transactions whereby every item is entered as a debit in one account and a corresponding credit in another.
Exception report	A short narrative report which highlights significant variances and/or areas for concern to accompany the management accounts.
External audit	A review of the year-end financial statements carried out by a professionally qualified and legally registered auditor resulting in an opinion about whether they give a true and fair view.
Financial accounting	Recording, classifying and sorting historical financial data, resulting in financial statements for those external to the organisation.
Fixed asset	An item of high value owned by the organisation for use over a long period. Normally office equipment, vehicles and property.
Fixed assets register	A list of the Fixed Assets of the organisation, usually giving details of value, serial numbers, location, purchase date, etc.
Fund accounting	Used to identify spending according to the different projects or purpose for which the funds were granted.
General ledger	The main accounting record where double-entry bookkeeping is used. See also *Nominal Ledger*.
General funds	Unrestricted funds which have not been earmarked and which may be used generally to further the organisation's objectives. Often referred to as Reserves.
Good Received Note (GRN)	Supporting document which accompanies deliveries of goods, signed by the person receiving the delivery to acknowledge the goods are received undamaged and as stated on the packing note.
Imprest	A type of cash float, set at an agreed level, which is topped up by the exact amount spent since it was last reimbursed, to bring it back to its original level.
Income & Expenditure Account	Summarises income and expenditure transactions for the accounting period, adjusting for transactions that are not yet complete or took place in a different accounting period.
Indirect cost	A cost which cannot be specifically assigned to one activity, department or project, eg the fee for the annual audit.

Journal entry	An entry in the books of account which covers a non-monetary transaction – eg for recording a donation in kind or an adjustment for correcting a recording error.
Liabilities	Amounts owed by the organisation to others, including grants received in advance, loans, accruals and outstanding invoices.
Liquidity	The level of cash and assets readily convertible to cash compared to the demands on the available cash. eg to pay bills.
Liquidity ratio	A measure of liquidity obtained by dividing debtors, cash and short-term investments by current liabilities.
Management accounting	The provision of financial information to management for the purposes of planning, decision-making, and monitoring and controlling performance.
Net book value (NBV)	The cost of an asset less its accumulated depreciation to date.
Net current assets	Funds available for conducting day-to-day operations of the organisation. Usually defined as current assets less current liabilities. Also known as working capital.
Nominal account	A ‘page’ or ‘container’ in the Nominal Ledger for recording every type of financial transaction likely to occur in an organisation, within a specified time period. A complete list appears in the Chart of Accounts, each with its unique ‘nominal code’.
Nominal ledger	A book or computer programme which holds details of each of the nominal accounts. Also known as General Ledger.
Organogram	Organisation chart showing the management and departmental structure of the organisation
Payment voucher	An internal document raised for each payment. It provides a unique reference number and evidence of authorisation. Supporting documents are attached to it.
Petty cash book	The day-to-day listing of petty cash paid out.
Prepayments	Amounts paid in advance at a particular accounting period – eg annual insurance premium.
Procurement	The process of purchasing goods and services. Steps in the process may include requesting, authorising, selecting suppliers, ordering, receiving and paying.
Quarter / quarterly	Three months of the accounting year, eg Quarter 1 (or Q1) would be 1 January to 31 March where the financial year runs from January to December.
Receipts & Payments account	A summary of the cash book for the period with opening and closing balances.
Reconciliation	Checking mechanism which verifies the integrity of different parts of an accounting system. Especially balancing the cash book to the bank statement.
Reserves	Funds set aside from surpluses produced in previous years.

Restricted funds	Income which has conditions attached to how used, usually with a requirement to report back to the donor.
Signatories	People who are authorised to sign cheques on behalf of the organisation.
Statutory audit	The annual external audit as required by law.
Statutory deduction	Amounts which must be taken from an employee's pay before they receive it, such as income tax or national insurance contributions.
Supporting document	The original documents that describe each transaction. These may include, receipts, invoices, delivery notes, sign sheets etc
Transaction	Any exchange of goods, services or money in return for other goods, services or money. Most commonly receipts and payments.
Trial balance	The list of debit and credit balances on individual nominal accounts from which an income and expenditure statement is prepared.
Trustee	A member of an NGO's most senior governing body, who shares overall responsibility for the NGOs work.
Unrestricted funds	Funds held for the general purposes of the organisation, for spending within the stated objectives.
Variance	The difference between the budget and the actual amount of income or expenditure.
Virement	The ability to transfer from one budget heading to another, for example if one budget line is under-spent, using the spare budget to offset an over-spend on another line.
Working advance	A sum of money entrusted to someone to spend on behalf of the organisation, which needs to be accounted for.
Working capital	See *Net Current Assets*.
Year-end	The cut-off point for the annual financial accounting period.
Zero-base budgeting	A method of preparing budgets which involves calculating estimates from scratch, by considering each cost area afresh.

Chapter
1

Financial Management for NGOs

An Introduction to Financial Management and Control in the NGO Sector

This chapter:

- Explains why financial management is important for NGOs
- Clarifies financial management and financial control
- Describes the underlying principles of financial management
- Explains roles and responsibilities in financial management
- Outlines the building blocks and tools of financial management.

Why is Financial Management important for NGOs?

In many NGOs financial management is given a low priority. This is often characterised by poor financial planning and monitoring systems.

But NGOs operate in a rapidly changing and competitive world. If their organisations are to survive in this challenging environment, managers need to develop the necessary understanding and confidence to make full use of financial management tools.

Good practice in financial management will:

- help managers to make effective and efficient use of resources to achieve objectives and fulfil commitments to stakeholders
- help NGOs to be more accountable to donors and other stakeholders
- gain the respect and confidence of funding agencies, partners and beneficiaries
- give the NGO the advantage in competition for increasingly scarce resources
- help NGOs prepare themselves for long-term financial sustainability.

Some very persuasive reasons for getting it right!

So what is Financial Management?

Financial management is not just about keeping accounting records. It is an important part of programme management and must not be seen as a separate activity left to finance staff.

> *Financial management entails planning, organising, controlling and monitoring the financial resources of an organisation to achieve objectives.*

Financial management to an NGO is rather like maintenance is to a vehicle. If we don't put in good quality fuel and oil and give it a regular service, the functioning of the vehicle suffers and it will not run efficiently. If neglected, the vehicle will eventually break down and fail to reach its intended destination.

In practice, financial management is about taking action to look after the financial health of an organisation, and not leaving things to chance. This will involve:

- **Managing scarce resources**

NGOs operate in a competitive environment where donor funds are increasingly scarce. We must therefore make sure that donated funds and resources are used properly, and to the best effect, to achieve the organisation's mission and objectives.

- **Managing risk**

All organisations face internal and external risks which can threaten operations and even survival (eg funds being withdrawn, an office fire or a fraud). Risks must be identified and actively managed in an organised way to limit the damage they can cause.

- **Managing strategically**

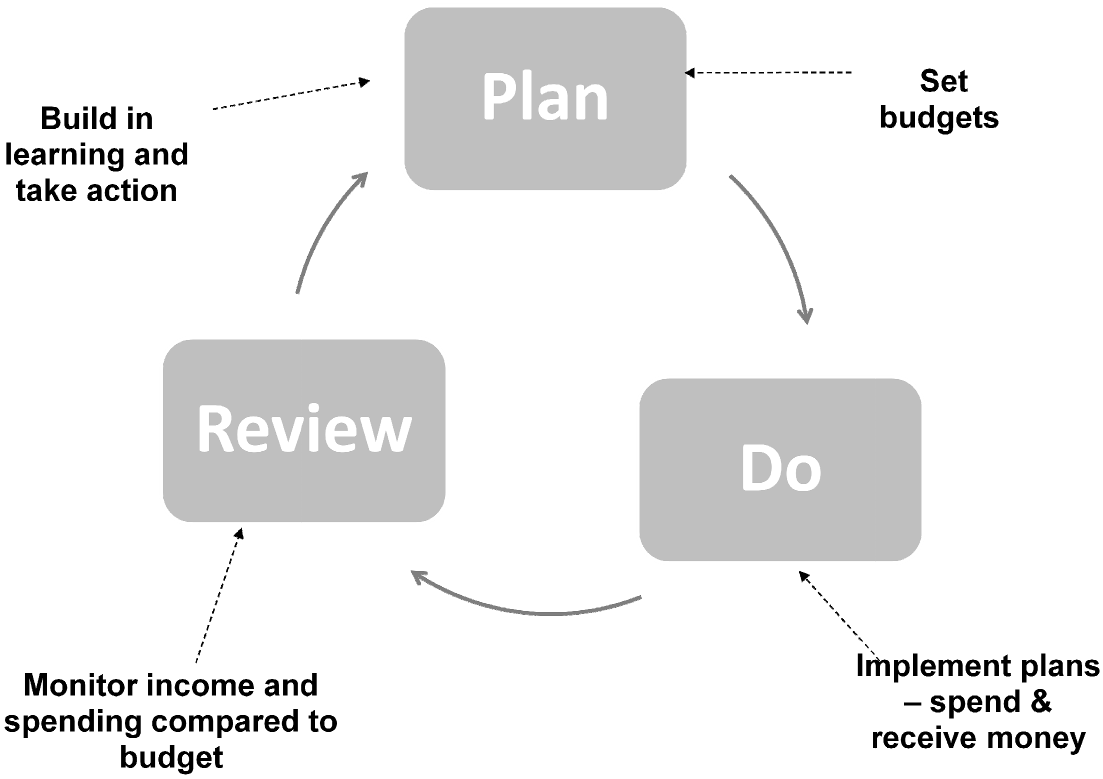
Financial management is part of management as a whole. This means managers must keep an eye on the 'bigger picture' – looking at how the whole organisation is financed in the medium and long term, not just focussing on projects and programmes.

- **Managing by objectives**

Financial management involves close attention to project and organisation objectives. The financial management process – **Plan, Do, Review** – takes place on a continuous basis.

The Plan-Do-Review cycle is illustrated in **Figure 1.1**.

Figure 1.1 – Plan-Do-Review



Plan:	When an organisation starts up, it sets its objectives and planned activities. The next step is to prepare a financial plan for the costs involved in undertaking the activities and where to obtain funds.
Do:	Having obtained the funds, the programme of activities is implemented to achieve the goals set out in the planning stage.
Review:	The actual situation is compared with the original plans. Managers can then decide if the organisation is on target to achieve its objectives within agreed time scales and budget. The learning from the review stage is then taken forward to the next planning phase, and so on.

What is Financial Control?

At the heart of financial management is the concept of financial control. This describes a situation where the financial resources of an organisation are being correctly and effectively used. And when this happens, managers will sleep soundly at night, beneficiaries will be well served and donors will be happy with the results.

> *Financial control occurs when systems and procedures are established to make sure that the financial resources of an organisation are being properly handled.*

With poor financial control in an organisation:

- assets will be put at risk of theft, fraud or abuse
- funds may not be spent in accordance with the NGO's objectives or donors' wishes and
- the competence of managers may even be called into question.

Who is Responsible for Financial Management?

It is important to understand an NGO's structure and legal status to appreciate who is responsible for what in financial management.

What is an NGO?

The term 'non-governmental organisation' tells us more about what it is not, rather than what it is. NGOs operate in a wide range of fields and come in all shapes and sizes. Whilst each one is unique, most share some common features:

- They are '**values-led**' – their prime motivation is a desire to improve the world in which we live.
- They are '**not-for-profit**' (but note that they are still allowed to make surpluses).
- They have many **stakeholders** – an NGO is an alliance of many different interests.
- They are governed by a **committee** of volunteers – the 'Governing Body'.
- They are private autonomous organisations, **independent** of the State.

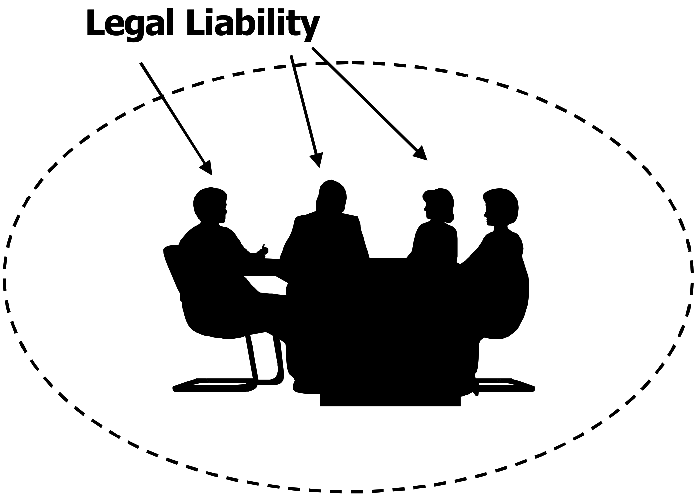
Legal Status

There are a number of different ways of registering as an NGO and this will determine the organisation's legal status. Organisations are recognised either as a separate legal entity (incorporated body) or as a loose collection of individuals (un-incorporated body).

Most smaller NGOs are un-incorporated. This means that trustees bear full responsibility and are held 'jointly and severally' (ie as a group and as individuals) responsible for the affairs of the organisation.

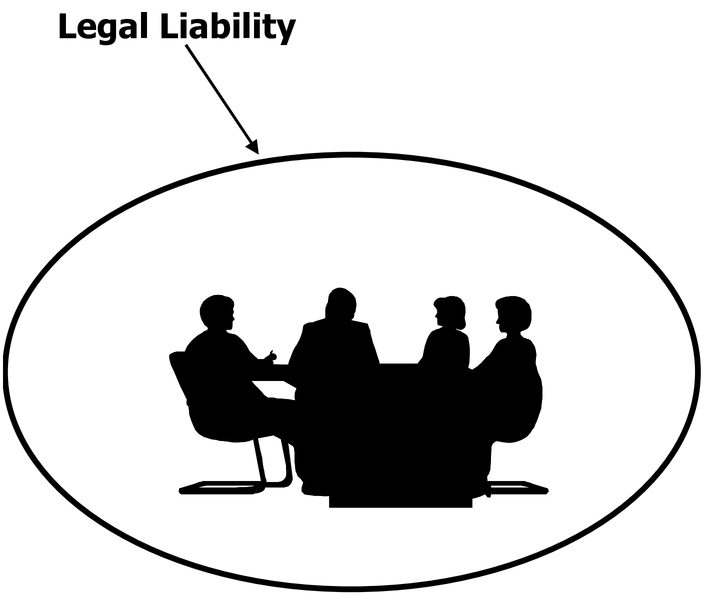
So individual board members could be named in a legal action, as shown by the arrows passing through the organisation's boundaries in **Figure 1.2**.

Figure 1.2: Unincorporated NGO



When a body is **incorporated,** it has a separate legal identity and is recognised in law as an 'artificial person' (demonstrated by the thick border protecting the individuals in **Figure 1.3**).

Figure 1.3: Incorporated NGO



In this type of body, individuals serving as board members have some protection in law. They have what is known as **limited liability.** This means that their financial responsibility, if things go wrong, is limited to a token amount (eg USD1.00).

Whatever the legal status, the trustees of an NGO together have a statutory duty to see that the organisation is being properly run and that funds are being spent for the purpose for which they were intended.

The Constitution

The way that an NGO is structured and registered will therefore have an impact on its legal status, accountability and transparency. Every NGO should have a founding document such as a Constitution or Memorandum and Articles of Association. This document describes, amongst other things:

- the name and registered address of the NGO;
- the objects of the organisation and target group;
- the system of accountability – ie who is the governing body, its powers and responsibilities;
- how it raises its funds.

The Governing Body

The governing body is **legally responsible** and accountable for governing and controlling the organisation. This means that if anything goes wrong in the NGO then the law holds the members of the governing body responsible.

It has many different names – Council, Board of Directors, Board of Trustees, Executive or Governing Board – and several functions including:

- responsibility for deciding on policy and strategy;
- custodianship (or safeguarding) of the financial and other assets of the organisation;
- appointing and supporting the Chief Executive; and
- representing interests of stakeholders.

The governing body is often organised with a series of sub-committees – eg Finance, Personnel or Project sub-committees.

Board Members

Board members are **volunteers** (ie not paid a salary) and are known variously as trustees, committee members, directors or council members. If board members were to benefit financially from their membership of the board, there could be a conflict of interest.

Honorary Officers are those who are elected or appointed to specific positions on the board – such as Chair, Treasurer and Secretary. They oversee the execution of board decisions and often sign legal undertakings.

- The **Chairperson** is usually the main point of contact for the Chief Executive Officer (CEO), and usually fulfils an important public relations role for the NGO.

- The **Treasurer's** role is to oversee the finances of the organisation. In a smaller organisation the Treasurer may take on a more active role and act as bookkeeper, but where there are paid staff, the Treasurer assumes more of a supervisory role.

Even if they are not supervising the accounting process and preparing reports themselves, board members must still be sure that everything is in order.

> *Board members are ultimately responsible for the financial affairs of the organisation and they cannot escape this duty except by resigning from the governing body.*

■ Day to day responsibility

As the governing body is made up of volunteers who meet only a few times a year, it delegates authority for day-to-day management to the CEO, appointed by the board to implement policy. The CEO then decides how to further delegate authority, to share out duties amongst the staff team.

While it is acceptable for the governing body to delegate authority to staff members, it **cannot delegate total responsibility** since ultimate accountability rests with the trustees. Furthermore, authority without accountability is unhealthy – the Board must set up monitoring mechanisms to make sure their instructions are being fulfilled.

Figure 1.4: Sample Organisation Chart – How authority is delegated

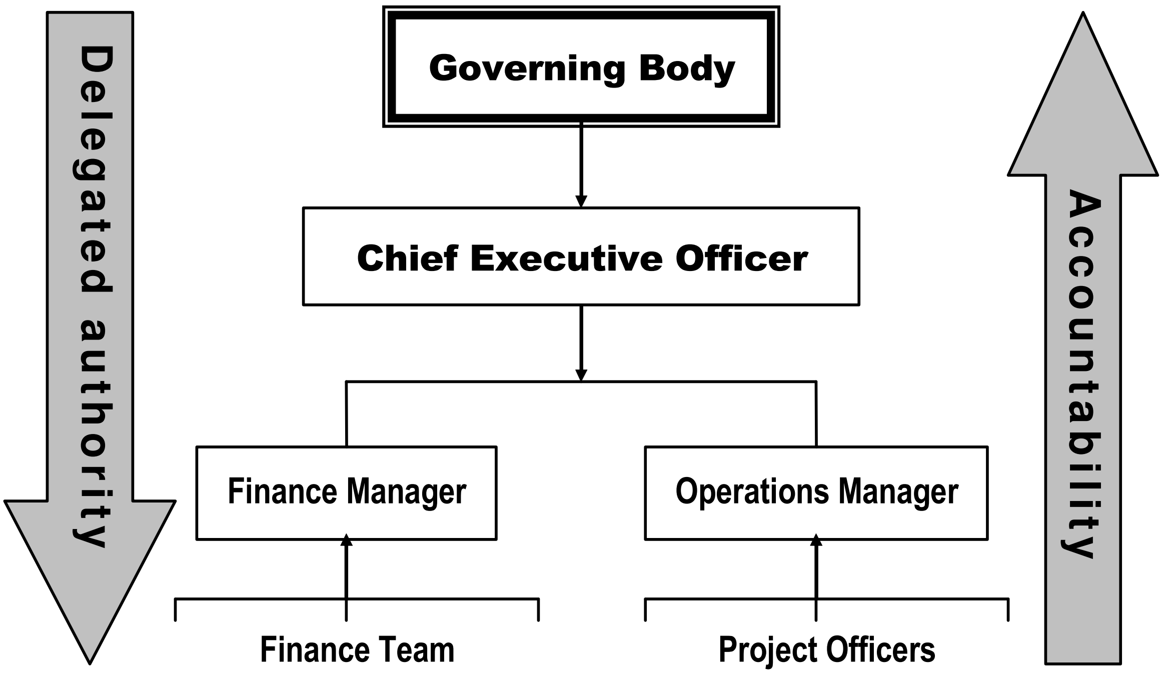


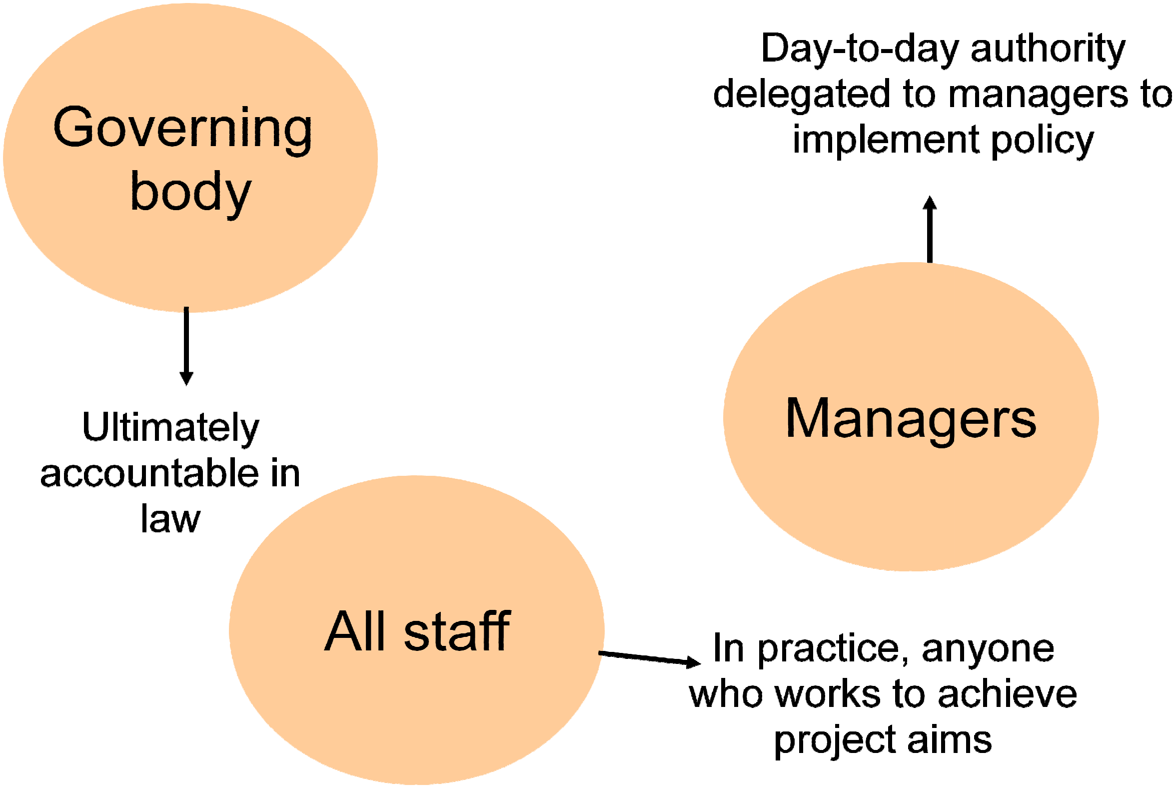
Figure 1.4 demonstrates how the authority for day-to-day financial management tasks is delegated down through the line management structure. At the same time, the accountability process comes back up through the structure as people report back on progress.

■ A Team Effort

In practice, everyone who works to achieve the objectives of an NGO has an important role to play in financial management. Every opportunity must be taken to integrate financial management into the day-to-day operational management of the organisation.

For this to happen, we have to get the basics right. We have to introduce robust systems and procedures and be guided by some important principles which underlie sound financial management.

Figure 1.5: Who is accountable?



The Seven Principles of Financial Management

It is useful to identify a series of good practice principles, which can be used as a standard in developing proper financial management systems in an NGO. These principles provide a high-level guide for trustees and senior managers to help them make sure that their organisation is using funds effectively and that staff are working appropriately.

Look upon each of the **Seven Principles of Financial Management** as goals to work towards.

- **Consistency**

The financial policies and systems of an NGO must be consistent over time. This promotes efficient operations and transparency, especially in financial reporting. This does not mean that systems may not be refined to cope with a changing organisation. Inconsistent approaches to financial management could be a sign that the financial situation is being manipulated.

- **Accountability**

The organisation must explain how it has used its resources and what it has achieved as a result to all stakeholders, including beneficiaries. All stakeholders have the right to know how their funds and authority have been used. NGOs have an operational, moral and legal duty to explain their decisions and actions, and submit their financial reports to scrutiny.

> ***Accountability*** *is the moral or legal duty, placed on an individual, group or organisation to explain how funds, equipment or authority given by a third party has been used.*

- **Transparency**

The organisation must be open about its work, making information about its activities and plans available to relevant stakeholders. This includes preparing accurate, complete and timely financial reports and making them accessible to stakeholders, including beneficiaries. If an organisation is not transparent, then it may give the impression of having something to hide.

- **Viability**

To be financially viable, an organisation's expenditure must be kept in balance with incoming funds, both at the operational and the strategic levels. Viability is a measure of the NGO's financial continuity and security. The trustees and managers should prepare a financing strategy to show how the NGO will meet all of its financial obligations and deliver its strategic plan.

- **Integrity**

On a personal level, individuals in the NGO must operate with honesty and propriety. For example, managers and Board members will lead by example in following policy and procedures and declare any personal interests that might conflict with their official duties. The integrity of financial records and reports is dependent on accuracy and completeness of financial records.

- **Stewardship**

An organisation must take good care of the financial resources it is entrusted with and make sure that they are used for the purpose intended – this is known as financial stewardship. The governing body (eg the Board of Trustees) has overall responsibility for this. In practice, managers achieve good financial stewardship through careful strategic planning, assessing financial risks and setting up appropriate systems and controls.

- **Accounting Standards**

The system for keeping financial records and documentation must observe internationally accepted accounting standards and principles. Any accountant from anywhere around the world should be able to understand the organisation's system for keeping financial records.

Tip: Use the 7 principles as a checklist to help identify relative strengths and weaknesses in your own organisation. To help you remember, a useful mnemonic formed by taking the first letter of each of the principles is **'CAT VISA'**.

The Four Building Blocks of Financial Management

There is no model finance system which suits all NGOs. But there are some basic building blocks which must be in place to achieve good practice in financial management.

- **Accounting Records**

Every organisation must keep an accurate record of financial transactions that take place to show how funds have been used. Accounting records also provide valuable information about how the organisation is being managed and whether it is achieving its objectives.

- **Financial Planning**

Linked to the organisation's strategic and operational plans, the budget is the cornerstone of any financial management system and plays an important role in monitoring the use of funds.

- **Financial Monitoring**

Providing the organisation has set a budget and has kept and reconciled its accounting records in a clear and timely manner, it is then possible to produce financial reports for all stakeholders. Internal budget monitoring reports help managers to monitor the progress of projects and annual financial statements provide accountability to external stakeholders.

- **Internal Controls**

A system of controls, checks and balances – collectively referred to as internal controls – are put in place to safeguard an organisation's assets and manage internal risk. Their purpose is to deter opportunistic theft or fraud and to detect errors and omissions in the accounting records. An effective internal control system also protects staff involved in financial tasks.

Figure 1.6: The Building Blocks of Financial Management – Getting the Basics Right

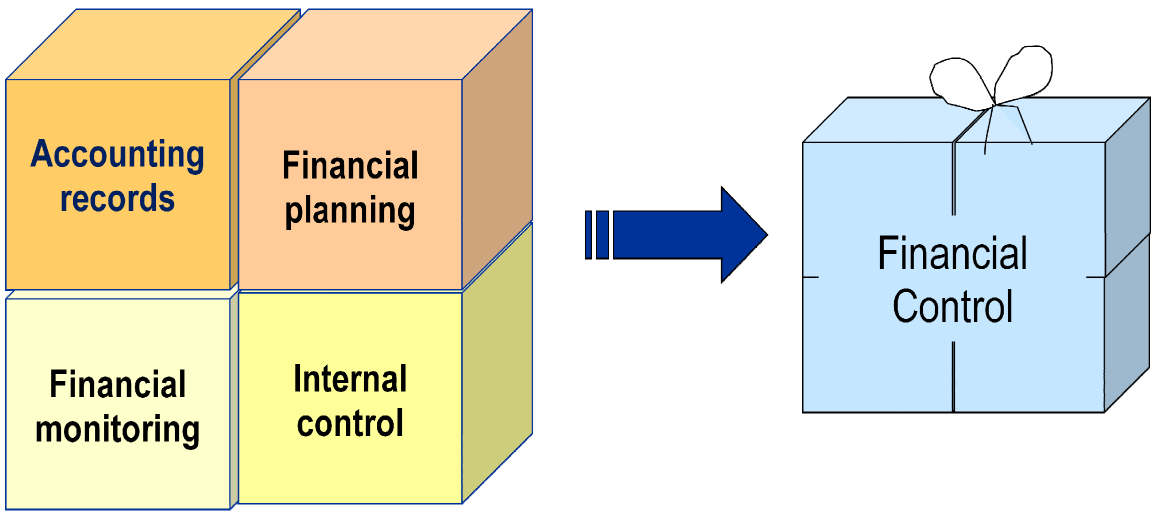


Figure 1.6 illustrates that all of the building blocks must be in place continuously. Effective financial control will not be achieved by a partial implementation.

For example, there is very little point in keeping detailed accounting records if they are not checked for errors and omissions; inaccurate records will result in misleading information, which in turn could wrongly influence a financial management decision.

The building blocks are covered in detail in the remaining chapters. They are also used as the basis for Mango's Financial Health Check – a self-assessment checklist to help you build your financial management systems. See Appendix 25, also available for free download here: http://www.mango.org.uk/Guide/HealthCheck (available in English and other languages).

The Tools of Financial Management

There are many tools, not necessarily financial, which managers can use to help achieve good practice in financial management and control.

We can identify these tools under each of the four functions of financial management (as highlighted in our working definition of financial management on page 2 of this manual):

- **Planning**

Planning is basic to the management process and involves looking ahead to prepare as well as possible for the future. In the course of putting a plan together managers will consider several possible alternatives and make a number of choices or decisions. Planning must always precede the doing.

Tools: Strategic plan, business plan, activity plan, budgets, work plans, cashflow forecast, feasibility study…etc.

- **Organising**

The resources of the organisation – staff and volunteers, vehicles, property, money – have to be co-ordinated to ensure implementation of the overall plan. It needs to be clear what activities and responsibilities are to be undertaken, when and by whom.

Tools: Constitution, organisation charts, flow diagrams, job descriptions, Chart of Accounts, Finance Manual, budgets…etc.

- **Controlling**

A system of controls, checks and balances are essential to ensure proper application of procedures and resources during programme implementation.

Tools: Budgets, delegated authority, procurement procedure, reconciliation, internal and external audit, fixed assets register, vehicle policy, insurance…etc.

- **Monitoring**

This involves producing regular and timely information for managers and stakeholders for monitoring purposes. Monitoring involves comparing actual performance with plans to evaluate the effectiveness of plans, identify weaknesses early on and take corrective action if required.

Tools: Evaluation reports, budget monitoring reports, cashflow reports, financial statements, project reports, donor reports, audit reports, evaluation report etc.

Can you identify the common tool that links all of the four functions of financial management?

Summary: Ten Reason for Financial Management

1. To be accountable to the people who give us money

With good financial management systems and procedures in place, it is easier to show donors and supporters that we are using their money for the purpose intended.

2. To be accountable to the communities we work with

Funds that NGOs raise are for the benefit of their beneficiaries. We have a moral obligation to show that funds raised in their name are being used correctly.

3. To be able to produce financial statements for regulatory bodies

We are required by law to provide financial information to regulatory bodies. If we do not do this, we might lose our registration and the right to operate.

4. To minimise the opportunity for fraud, theft and abuse of equipment

Good financial management includes internal controls. When these are in place they help to stop fraud and protect the staff as well as the assets.

5. To plan for the future and become more financially secure

We have to plan to make sure we have enough money to carry out our objectives. Budgets help us plan for projects and manage cash. Financial information helps us to identify potential financial risks and the need for savings (reserves). Financial sustainability is all about achieving long term financial continuity and security – this is not easy to do. We need financial information about where we are now and where we want to be in the future, to help identify our long-term financing needs.

6. To enable staff to make better decisions on the use of funds

Complete, up-to-date and timely project monitoring reports enable project managers to plan their activities according to the budget available and take decisions to fulfil objectives. Good cash flow management enables activities to be planned, items purchased when needed and staff paid on time.

7. To achieve the objectives of the organisation

Good financial management will give the management team and Board the information they need to ensure they are fulfilling the objectives of the organisation and following the strategic plan.

8. To enhance the credibility of the organisation

NGOs who keep good accounts create great budgets and produce accurate and timely financial reports inspire confidence and trust in their stakeholders. This gives well-run organisations an advantage over their competitors.

9. To strengthen fundraising efforts

NGOs who present good budgets and audited financial statements with funding proposals are more likely to receive a favourable response.

10.To get better value for our money

Financial information allows us to compare and assess spending plans to make sure we make efficient, effective and economic use of financial resources.

Chapter 2

Getting Organised

Getting the basics right for your NGO

This chapter:

- Explains why it is important to design financial systems which are right for your NGO
- Describes the two branches of accounting
- Introduces the Chart of Accounts and Project Cost Centres and their important role in organising the accounts
- Defines different types of costs
- Looks at the role of financial policies and procedures
- Explains what a finance manual is and what goes in it.

Systems Design

Systems design is one of the organising aspects of financial management. NGOs are quite different from commercial organisations and state institutions, and financial systems have to be adapted to meet their needs and resources.

The key tools to help to get your systems organised include:

- Organisation chart and job descriptions of staff
- Financial accounts structure – including a Chart of Accounts and Project Cost Centres
- A 'Finance Manual' – or a file of established policies and procedures
- A financial year planner

Financial systems design must also cater for the two distinct, but inter-dependent, branches of accounting: financial accounting and management accounting.

Financial Accounting vs. Management Accounting

For the financial management process to take place effectively, financial systems and procedures need to cover two aspects of accounting.

■ Financial Accounting

This describes the systems and procedures used to keep track of financial and monetary transactions which take place inside an organisation. Financial accounting is a system of recording, classifying and summarising information for various purposes.

Financial accounting records can be maintained either using a manual or computerised system (or a combination of both methods). Although it is important to comply with certain accounting conventions and standards, the actual system adopted will depend on:

- the expertise and resources available
- the volume and type of transactions
- reporting requirements of managers
- obligations to donors and
- the communities NGOs work with.

One output of financial accounting is the annual financial statement, used primarily for accountability to those external to the organisation. The routine output of financial accounting throughout the year must be accurate and up-to-date if the second area is to be undertaken effectively and with minimum effort.

■ Management Accounting

Management accounting takes the data gathered by the financial accounting process, compares the results with the budget and then analyses the information for decision-making and control purposes. The reports produced by the management accounting process are therefore primarily for internal use.

Financial Accounting:	**Management Accounting:**
Records transactions	Compares results against goals
Classifies transactions	Determines reasons for variations
Reconciles records	Helps identify corrective action
Summarises transactions	Forecasting & planning
Presents financial data	Analyses information

These reports should be produced on a regular basis – usually monthly or quarterly depending on the needs of the organisation – and as soon as possible after the reporting period so that figures are relevant to managers' discussions.

The Right System?

Every NGO is different – there is no such thing as a 'model' finance system. So there are a number of considerations to take into account to find the right approach for your NGO:

- **Structure** – line management; number of staff, their functions and where they are based; operational structure (eg department, branch, function). *Organograms* are useful here.
- **Activities** of the organisation – number and type of projects.
- **Volume and type of financial transactions** – do you pay for your goods and services with cash or with suppliers' accounts or both?
- **Reporting** requirements – how often and in what format do financial reports have to be produced for the different stakeholders in your organisation?
- **Resources** of the organisation – what financial, equipment and human resources are available to help manage the finances?

All of these considerations will help to decide the most appropriate:

- method for keeping accounting records
- coding structure for transactions
- financial policies
- financial reporting routines
- use of computers
- use of administrative staff.

The Chart of Accounts

The Chart of Accounts is probably the most important organising tool for the accounting and reporting processes.

There are many different kinds of financial transaction taking place in an NGO. We buy a wide variety of goods and services to help achieve our objectives – from rent for the office to tools for a garden project. And we receive different kinds of income – grants, donations and membership fees, for instance.

To make sense of all of this financial activity, it helps to 'sort' the different types of income and expense into a series of pre-determined categories or Accounts. These Accounts are listed in the Chart of Accounts and are typically arranged in a logical order: Income and Expenditure, Assets (things we own) and Liabilities (things we owe).

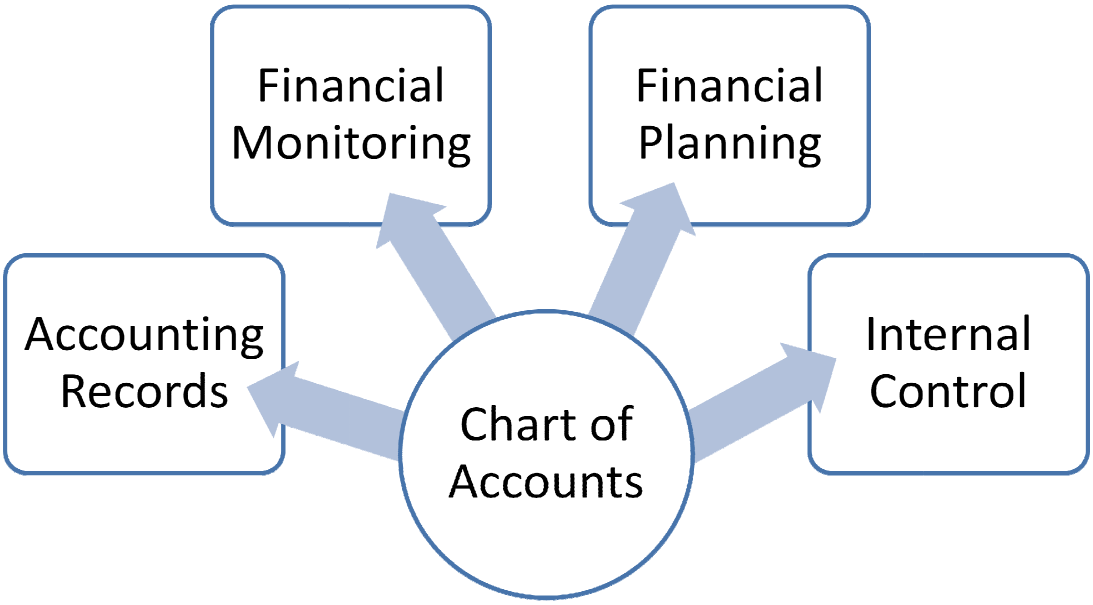
Then, when a transaction takes place, it is recorded in the books of account and categorised according to the guidance held in the Chart of Accounts. The same categories are used in the organisation's budget and financial reports, so promoting consistency and transparency.

Each organisation's Chart of Accounts will be different. Typically, the layout will include account name, reference number and a description for use of the account. An example of a Chart of Accounts can be found in Appendix 1.

Note that the categories have been sorted not only by type of Account, but also into sub-groups under 'family' headings – such as Administration, Personnel and Vehicle Running.

Family headings are especially useful for presenting summarised information. The coding method used (in this case a numerical system but alphabetical systems are also used) follows the same logic using a group of numbers for the same family of items.

Figure 2.1: The Chart of Accounts in a Finance System



Cost Centres

Some grants are given for a specific purpose – these are known as *restricted funds* because they may only be used for a particular activity, rather than for general purposes. Such funds must be accounted for separately so that the organisation can demonstrate to the donor how the funds have been utilised. This is known as *fund accounting* and requires care when setting up accounting systems to identify and separate the necessary information.

In such circumstances it may be appropriate to identify activities within an organisation by **Cost Centre** (or Activity or Budget Centre). Cost centres are typically applied to projects, functions or departments which have their own budget and funding sources.

The starting point for deciding on a cost centre structure is the organisation chart and donor funding agreements.

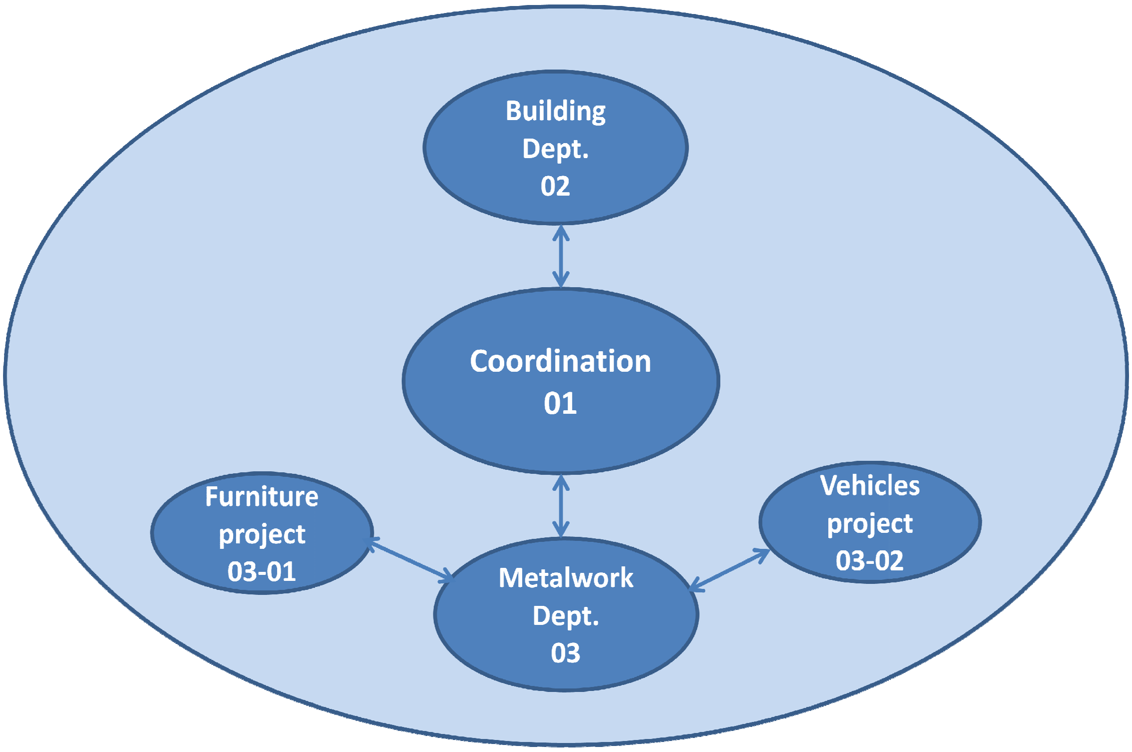
Example

Milestone has three departments: Coordination (ie management, administration and governance), Metalwork Department and Building Department. The Metalwork department in turn has two separate activities with their own funding sources: the Furniture Project and the Vehicles Project.

A useful way to graphically present cost centres is in the form of an 'egg chart' (see **Figure 2.2** for Milestone's chart).

Their cost centre structure and reference codes are shown in Appendix 1 (page A2).

Figure 2.2: Milestone's Cost Centres



There is no effective limit on the number of cost centres that can be used especially if a computer accounting program is used. However, it is important to design the cost centre structure carefully to prevent record keeping become burdensome and counter-productive. Each cost centre is given a unique reference or code to identify it within the records.

■ How are cost centres used?

With cost centres in place, when financial transactions are entered into the accounting records not only are they categorised by the type of income or expenditure...

'Which _budget line item_ *does this belong to?'*

but also classified according to the fund, department or project….

'Which project, donor or department budget does this belong to?'

This means that separate financial reports can be more easily produced for each cost centre, helping managers to monitor their own area of responsibility and report to project donors.

Cost Structures

As well as identifying the different types of expenditure for your organisation, you also need to be able to classify them as either *Direct* or *Indirect* costs.

- **Direct costs** are those which are clearly related to a particular activity and can be charged directly to the relevant Cost Centre. For example, in a training project, the costs of room hire for a training event and the trainer's salary.
- **Indirect costs** are those which are of a more general nature and relate to the organisation as a whole or more than one activity. For example, head office rent, the audit fee and the Chief Executive's salary. These usually form the bulk of what are known as the 'core' (or overhead or central administration) costs.

We need to distinguish between these two types of cost in the accounts so that managers can properly plan, monitor and control their project resources. In particular, core costs have to be shared out – or apportioned – between the different projects in a fair and justifiable way. There are various ways to do this, for example sharing costs according to the size of each project budget (more on this in a later chapter).

Financial Policies and Procedures

All organisations need to set down a series of financial policies and procedures to guide operations and avoid misunderstandings.

■ What is a policy?

A policy sets out principles and guidelines for a key area of activity within an organisation. It removes any questions about how important resources are used. For example, a Vehicle Policy will clarify who can drive the NGO's vehicles, how they are disposed of and rule on private usage by staff.

Policies are usually written by senior managers and then discussed and agreed by the Board or management team. Once approved, a policy is binding on everyone in the organisation and failure to do so could result in disciplinary action.

Policies should stand the test of time – whilst it is important to be flexible, NGOs should not change policies too often.

What makes a good policy?

- It is fair and realistic
- Is covers all situations likely to arise
- It meets legal requirements
- It is affordable for the organisation.

■ What are procedures?

Procedures describe the steps for carrying out the guidelines in a policy. They often include a requirement to complete standard forms to gather data and authorisation for actions. For example, the Vehicles Procedure might require completion of vehicle requisition forms and journey log-sheets.

> *Policies and procedures are not about being overly bureaucratic. They help to run the organisation smoothly and promote consistency, accountability and transparency. They also facilitate the decentralisation process and help managers make the right decisions.*

■ Developing Financial Policies

It is important to have a structured approach to developing financial policies, to make sure that the policy is fair, realistic and acceptable to those that will be affected. People are more likely to adhere to policies if they had a say in making them.

Here are some ideas for you to consider.

Decide who will be involved in drawing up the policy

If the policy is to have an impact on how programmes are delivered, it makes sense to include programme staff in the discussions.

Do some background research to gather the information you need to develop the policy

For example, if you were setting a policy on health-care support for staff, ask around other NGOs to see what they offer and what it costs.

Write the policy document

Use the following headings as a guide:

- The purpose of the policy
- Why we need the policy
- Who the policy applies to
- The policy guidelines
- References (eg to other policies and procedures)

Circulate the draft policy for feedback

It is this stage that will check if the policy is fair and realistic and whether it is likely to be supported (and therefore used).

What is a Finance Manual?

The Finance Manual brings the financial policies and procedures all together in one document. The manual may also be known as the Financial Regulations or Finance and Office Procedures.

It is generally used by the accounts staff for day-to-day operations but also serves as a reference in case of query by programmes staff.

■ What goes in a Finance Manual?

A finance manual might include sections on:

- Financial accounting routines
- The Chart of Accounts and cost centre codes
- Delegated authority rules (ie who can do what)
- The budget planning and management process
- Ordering and purchasing procedures
- Bank and cash handling procedures
- Management accounting routines and deadlines
- Management and control of fixed assets
- Staff benefits and allowances
- Annual audit arrangements
- How to deal with fraud and other irregularities
- Code of Conduct for staff and board members

The manual may also include some reference materials such as

- Organisation Chart
- Job Descriptions
- Standard forms.

Be aware of the limitations of a Finance Manual: it is a major undertaking and it cannot cover everything, to do so would be too bureaucratic; and it must be a 'living' manual, used and implemented by everyone and regularly reviewed and updated.

The process of developing policy and procedures together is far more important that the finance manual itself – people need to 'own' and implement them, rather than see them as a 'rule book'.

Standard Forms

Standard forms are purpose-designed documents used to simplify or facilitate financial administration routines [see Appendices 18-22 for some commonly used standard forms]. They are one of the best ways to ensure that procedures are followed and understood by those responsible for operating them.

Standard forms can be used with almost any procedure but especially where:

- ✓ information needs to be supplied by a third party before a transaction can take place
- ✓ a transaction requires to be checked and authorised or
- ✓ financial information is being summarised or reconciled.

A note of caution in the use of standard forms: do not overdo the paperwork as too much bureaucracy slows down the accounting process and overloads the authorisation routines.

Some typical uses for standard forms:

- Supplies requisition
- Payment voucher
- Petty cash voucher
- Purchase order
- Working advances request
- Travel and subsistence expenses claim
- Assets register
- Vehicle log sheet
- Bank reconciliation form
- Journal voucher
- Staff loan application.

Work Planning

Financial management involves many different tasks and routines. It is therefore important to plan tasks involved during the financial year, such as:

- Financial accounting routines – eg month-end and quarter-end reconciliation, payment runs
- Critical deadlines – eg payment of government taxes, insurance renewals
- Reporting schedules – especially to meet donors' reporting requirements
- Budgeting process

- Annual reviews – eg assets register, finance manual and insurance cover
- Year end procedures – eg closing accounts and annual external audit.

One of the best ways to do this is to create a yearly planning chart and put this up in your office and encourage everyone to keep it up to date. This helps to schedule tasks and allocate tasks to staff so that deadlines can be met.

See Appendix 17 for an example.

Chapter 3

Financial Planning

'Failing to plan is planning to fail.' (Chinese Proverb)

This chapter:

- Describes the planning process and how it links with financial management
- Highlights different types of budgets and when to use them
- Describes different approaches to budgeting and how to use a budget worksheet
- Looks at good practice in budgeting
- Introduces a tool for managing multiple-donor projects.

The Financial Planning Process

Financial planning is both a strategic and operational process linked to the achievement of objectives. It involves building both longer term funding strategies and shorter-term budgets and forecasts. It lies at the heart of effective financial management.

Financial planning does not start with budgets and numbers. It is impossible to start a financial forecast without a clear idea about what it is you want to do and how you intend to do it. So we can only produce effective budgets if we have good plans to base them on.

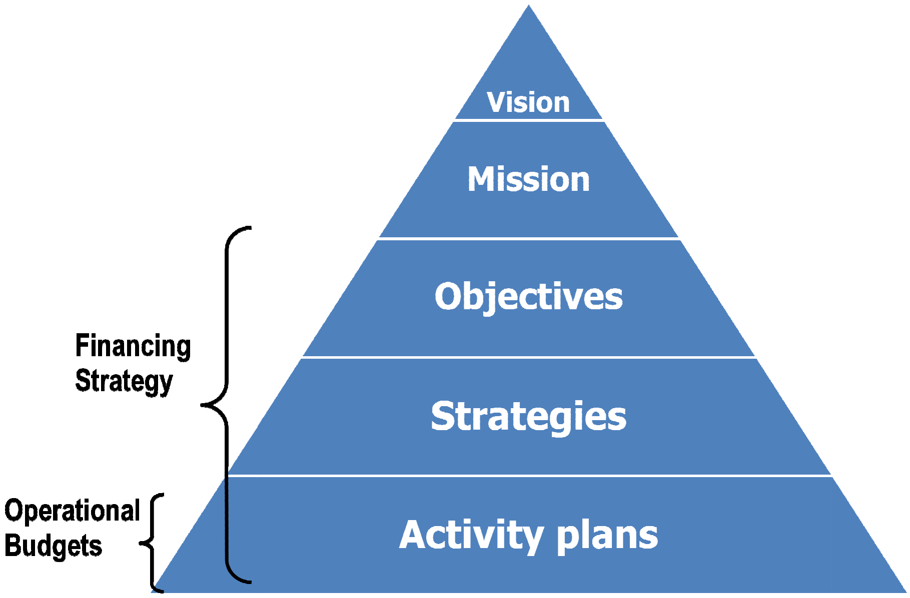
> *"If you don't know where you are going then you are sure to end up somewhere else."*
> ***Mark Twain***

■ The Planning Pyramid

NGOs exist to achieve certain objectives. It is usual to lay down how the objectives are going to be achieved in a Strategic Plan.

The strategic planning document has several component parts starting with an outline of long term goals – either or both a Vision and Mission – and going into greater and greater detail about how the mission is to be achieved.

Figure 3.1 The Planning Pyramid



As the level of detail increases, the timeframe becomes shorter and participation of staff members in the planning process should increase.

Vision

The vision represents the very long-term goal of the organisation – it is the big problem which the NGO alone cannot solve but strives towards. For example, the United Nations' underlying vision is 'World Peace'.

Mission

Most NGOs have a mission statement as part of their founding documents. It clarifies the purpose and values of the organisation in a few, general, sentences.

Objectives

Objectives are the building bricks which help an organisation achieve its mission. Objectives (also known as Goals or Strategic Objectives) give focus to the organisation's work and state in clear terms what it is that the organisation hopes to achieve over a given timeframe.

Strategies

Strategies (also known as Specific Objectives) set out how the organisation will achieve each of its core objectives. They outline the actions which will be taken for each objective.

Activity Plans

The strategy may be sub-divided into several, more specific and detailed plans for each activity, function or project. Activity plans have a shorter time focus (about one year) than strategies and objectives and are subject to regular review as progress is made. Activity plans are the basis for budgets so must be very '**SMART** '– specific, measurable, achievable, relevant (or realistic) and time-bound

Once plans are set, the organisation draws up its budgets and cashflow forecast to help implement the plans. During the year financial reports are produced to compare the budget with actual performance.

This review stage is very important to the financial planning process since it will highlight areas where the plans did not happen as expected. This learning process will help to identify revisions which need to be made to the plans.

And so the cycle continues… *Plan, Do, Review*.

What is a Budget?

> *'A budget describes an amount of **money** that an organisation **plans** to raise and spend for a set **purpose** over a given period of **time**.'*

A budget has several different functions and is important at every stage of a project:

- **Planning**

A budget is necessary for planning a new project, so that managers can build up an accurate idea of the project's cost. This allows them to work out if they have the money to complete the project and if they are making the best use of the funds they have available.

- **Fundraising**

The budget is a critical part of any negotiation with donors. The budget sets out in detail what the NGO will do with a grant, including what the money will be spent on, and what results will be achieved.

- **Project implementation**

An accurate budget is needed to control the project, once it has been started. The most important tool for on-going monitoring is comparing the actual costs against the budgeted costs. Without an accurate budget, this is impossible. Because plans sometimes change, it may be necessary to review the budget after a project has started.

- **Monitoring and evaluation**

The budget is used as a tool for evaluating the success of the project, when it is finished. It helps to answer the question: 'Did the project achieve what it set out to achieve?'

Who needs Budgets?

> *"A budget tells your money where to go; otherwise you wonder where it went."*
> ***J. Edgar Hoover***

Budgets are used by different people for different purposes.

- The **Board of Trustees** needs the NGO's overall budget because it has to formally approve it and monitor its progress.
- NGO **Chief Executives** need budgets to keep an eye on progress of the whole organisation and the funding situation.
- **Project managers** need budgets to oversee the implementation of their project activities.
- **Fundraisers** need budgets to accompany funding applications.
- **Finance staff** need budgets to make sure there are enough funds in the bank to cover anticipated expenditure.
- **Donors** need budgets so they can see how an organisation intends to spend its grants.
- **Community partners** need budgets so they can see how an NGO plans to spend and raise funds for their community projects.

Types of Budget

Essentially, there are three main types of budget:

- ✓ The Income and Expenditure Budget
- ✓ The Capital Budget
- ✓ The Cashflow Forecast

■ The Income and Expenditure Budget

The income and expenditure budget sets out the anticipated running costs (also referred to as recurrent costs) of the organisation and shows where the funds will come from to cover the costs [see Appendix 11 for a Consolidated Income and Expenditure budget].

The annual income and expenditure budget is often broken down into shorter periods (or 'phases') – quarterly or monthly – to assist with monitoring progress.

■ The Capital Budget

A capital budget lists the expenditure you intend to make for the coming years on capital projects and one-off items of equipment that will form part of the organisation's *Fixed*

Assets. As these usually involve major expenditure and non-recurrent costs, it is better to list and monitor them separately. Examples of capital expenditure include:

- Vehicles
- Office furniture and equipment
- Computer equipment
- Building construction
- Major renovation works

The implications for the income and expenditure budget should be noted – such as running costs for vehicles. A separate capital budget is not required if only one or two capital items are to be purchased. In this case it is sufficient to incorporate the capital items in a separate section of the income and expenditure budget. This is most common in a project budget.

■ The Cashflow Forecast

For good cash and financial management, cash reserves are essential as there will always be times when grants are delayed or unexpected expenses occur.

The cashflow forecast (or cash budget) helps managers identify those times when cash levels become critical. It predicts the flow of cash in and out of the organisation throughout the year by breaking down the master (or overall) budget into smaller time periods, usually one month.

Whereas the income and expenditure budget shows whether the organisation is covering its costs over the whole year, the cashflow forecast shows whether it has sufficient cash in the bank to meet all of its obligations needs as they arise. [See Appendix 13 for an example.] This helps to identify likely cash shortages and allows avoiding action to be taken such as:

- requesting donor grants early;
- delaying payment of certain invoices;
- delaying some activities; or
- negotiating a temporary loan facility at your bank.

However, take care as there are likely to be negative consequences if you follow the last three strategies:

- Delaying payments could affect your relationship with suppliers
- Delaying activities will affect the communities you work with and your ability to implement the programme as agreed with your donor
- Borrowing money from the bank will attract bank charges and interest.

The cashflow forecast is also useful where the organisation maintains substantial cash reserves which need to be invested wisely to maximise investment income.

How to prepare a cashflow forecast

To prepare a cashflow forecast, you will need all of the organisation's activity plans and budgets for the year. This exercise is best completed using a computer spreadsheet such as Excel.

For each item of income and expenditure on the budget, you need to predict and plot on the forecast sheet when cash will come in and go out. This is dependent on when activities are planned to take place. Some activity is more predictable than others, eg monthly such as salaries or annual such as insurance and audit fees. Other transactions are unpredictable, eg repairs.

Once the budget has been broken down into each month based on the activity plans, it is possible to calculate the net cash flow: ie whether there is more cash coming in or going out, or vice versa. It is usual to also include an estimate of any bank balances held as reserves as this will help manage our cash flow.

Tips on Preparing a Cashflow Forecast

1. Cashflow forecasts are not simply the budget broken down into 12 equal instalments - you need to know when specific activities will take place. Eg for a training project, when will the courses take place, when will costs have to be paid and will the course fees be paid in advance?
2. Expenses must be entered on the cashflow forecast when the cash is expected to leave the bank. So an invoice for January's electricity will probably be received in February and paid in March.
3. Some payment are paid monthly, such as salaries. But don't forget that deductions, such as income tax, are often paid to the authorities the month after salaries are paid, or in some cases paid annually.
4. You need to take account of payment terms and income schedules. E.g. in some countries, auditors require a 50% deposit of the audit fee before the audit and the rest follows after the report is filed; so although this is an annual activity the actual cash movement is affected by payment terms. Similarly, grant schedules dictate the inflow of cash from donors.
5. For unpredictable expenses – e.g. equipment repairs – it is best to put a monthly or quarterly sum.
6. Obvious but easily forgotten: you exclude non-cash transactions from the cashflow forecast (eg donations in kind or depreciation) so if these are on the budget, they have to be left off the cashflow.
7. If there is not enough money in the bank to pay for project activities, delays will follow and donors will get upset – so cashflow forecasting is really important!

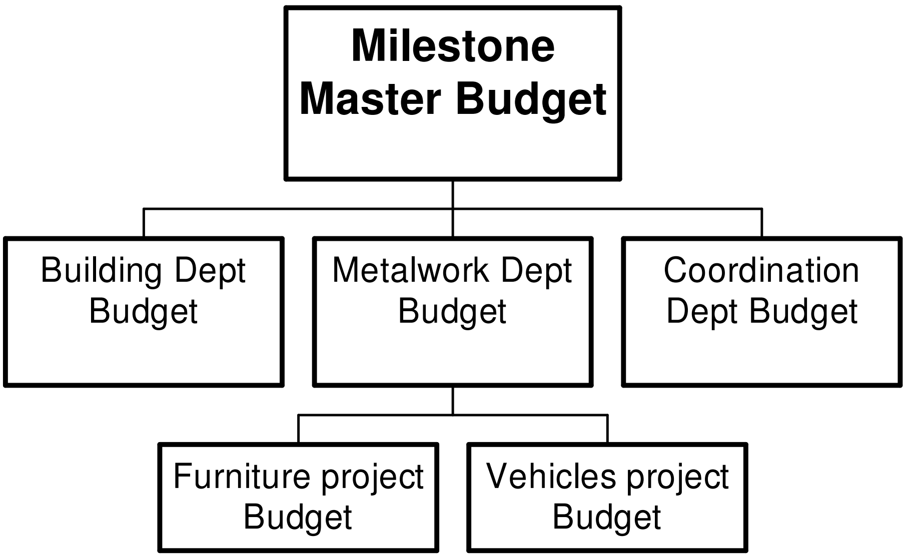
Budget Structures

To facilitate planning and to enable control to be effective, many organisations try to ensure that the overall structures of their budgets correspond closely to the organisation structure. It is possible to organise budgets at different levels, eg by department, programme or project.

Figure 3.2 shows Milestone's budget hierarchy. Note that this reflects the cost centre structure that we looked at in the last chapter. The lower level project budgets are consolidated into the departmental budget. Departmental budgets are in turn consolidated into one master budget (see Appendix 11).

This structure allows budgets to be delegated and monitored at the project level, whilst maintaining an overview at department and association level.

Figure 3.2: Milestone's budget structure



Budgeting Techniques

There are two main ways to build a budget – *incremental* and *zero-base*. You should adopt the approach which works best for you, given the skills and time available.

- **Incremental budgeting**

This approach bases any year's budget on the previous year's actual, or sometimes budgeted, figures with an allowance for inflation and known changes in activity levels. It has the advantage of being fairly simple and quick to implement. It is most useful for organisations where activity and resource levels change little from year to year.

A frequent criticism of this approach is that it does not encourage fresh thinking and may perpetuate existing inefficiencies. It also makes it difficult to justify the figures to donors since the original calculations may be long forgotten.

■ Zero-based budgeting

An alternative approach is to start with a clean sheet – a zero base. Zero-base budgeting (or ZBB) ignores previous experience and starts with next year's targets and activities. ZBB requires the writer of the budget to justify all the resource requirements.

This process may suit organisations going through a period of rapid change and those, like NGOs, whose income is activity-based. Zero-based budgets are said to be more accurate since they are based on the detail of planned activities. However, the approach does impose a much greater workload on managers than incremental budgeting.

■ Activity-based budgeting

This is a special form of Zero-base budgeting and is frequently used in the NGO sector to create project budgets and is favoured by many donors. See Appendix 12 for an example.

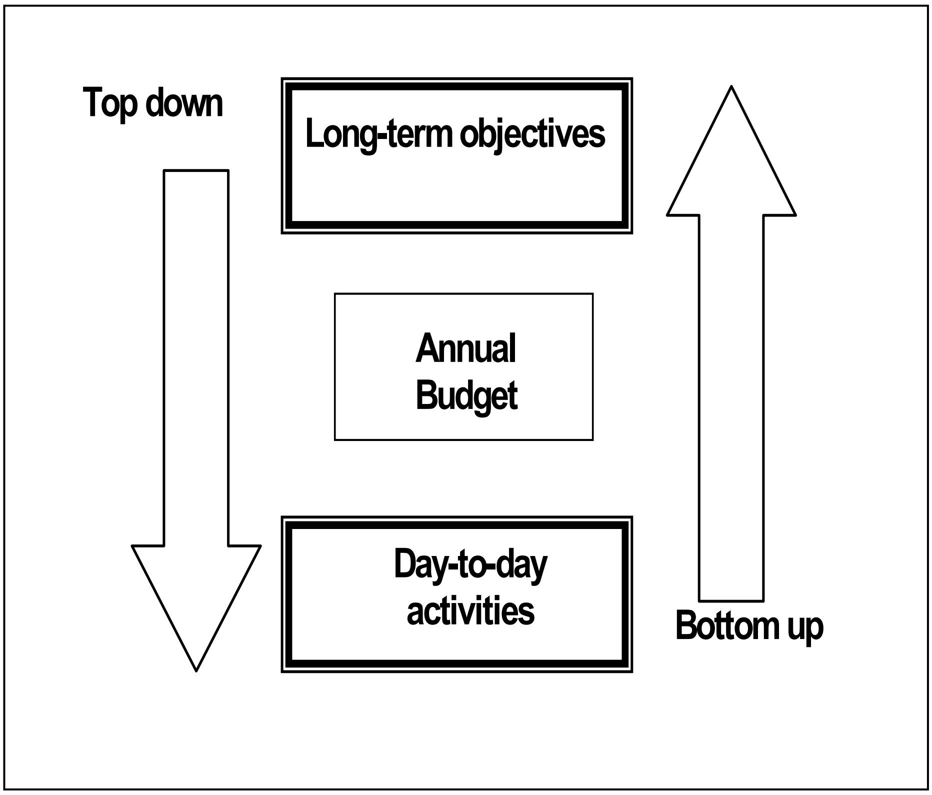
■ Top Down or Bottom up?

Since a budget is a financial plan that relates directly to the activities of the organisation, it is important that those who will be responsible for project implementation are closely involved with writing the budget.

If this is not done, the budget will surely be less accurate and the staff less likely to appreciate the need to spend within budget or to reach fund-raising targets.

Where operations staff are involved in setting their budgets it is described as **'bottom up'** budgeting – as opposed to **'top down'** where budgets are imposed by senior managers. Many organisations employ a mix of top down and bottom up approaches.

Figure 3.3: Top Down vs. Bottom up



Summary of Budget Terminology

MAIN TYPES OF BUDGET	**Income & Expenditure**	This budget lists all items of incoming funds and recurrent (ie regularly occurring) costs for a specified period.
	Capital	This budget lists one-off expenditure for expensive items such as equipment, property, vehicles, or major building works, which will be used over several years.
	Cash flow forecast	This budget shows the predicted flow of cash coming in and out of the organisation each month, with the purposes of identifying periods of cash shortages or surpluses.
BUDGET STATUS	**Balanced**	This budget shows that anticipated income is the same as anticipated expenditure
	Deficit	This budget shows that anticipated income is less than anticipated expenditure
	Surplus	This budget shows that anticipated income is more than anticipated expenditure
APPROACHES TO WRITING A BUDGET	**Incremental**	This describes an approach to budgeting where the calculations are based on previous year's budgeted or actual figures, with adjustments for new activities or known changes
	Zero-base	This describes an approach to budgeting where the budget is built from 'scratch', and not based on previous budgets or figures.
	Activity based	This describes an approach to budgeting where the budget is built up from a detailed activity plan (a form of zero-base budgeting).
LEVEL OF BUDGET DETAIL	**Master**	This budget shows overall anticipated income and expenditure for the whole organisation for the year.
	Consolidated	This brings together several project or programme budgets in a table to show a summary of each <u>and</u> the total overall.
	Project or programme	This budget shows income and expenditure for a specified project or programme for the implementation period.
TIME PERIODS	**Multi-year**	This budget outlines anticipated income and expenditure, or cashflow, for two or more successive years.
	Phased	This describes a budget which has been broken down into smaller time periods – usually monthly or quarterly – to reflect the budget requirements for that period, according to levels of activity.
SPECIALISED BUDGETS	**Donor**	This budget is produced in the format required by a funding agency and usually accompanies a funding proposal.
	Flexible (or variable)	This budget is regularly reviewed and updated to take account of changes in levels of activity
	Funding grid	This is a special budget which reconciles anticipated income sources to the programme budget, to show which funding source is funding what, and identify funding gaps.
	Rolling	This budget always covers a fixed period of months (eg 12 months). It is updated every month or quarter to include figures for the fixed budgeting period.

The Budgeting Process

The process of preparing a meaningful and useful budget is best undertaken as an organised and structured group exercise. The budget process involves asking a number of questions:

- What are the objectives of the project?
- What activities will be involved in achieving these objectives?
- What resources will be needed to perform these activities?
- What will these resources cost?
- Where will the funds come from?
- Is the result realistic?

Once the budget has been agreed and the activity implemented, the process is completed by comparing the plan (budget) with the eventual outcome ('actual'), to see if there is anything we have learnt or could do differently next time.

The budgeting process is one we go through almost on a daily basis without even realising, as the example below demonstrates.

Example: Rudi goes to a football match

It is Friday afternoon and a teenage son – Rudi – rushes in from school asks his mother for \$10.00 as he'd like to go out with some friends for the evening. His mother asks him to explain what he will be doing and why he needs \$10.00.

He says he will take the bus into town, go for some food and then go to watch a football match. His mother then took him through the budgeting process, as follows:

Objective: To have an entertaining evening with friends.

Activities: Bus journey to town, visit a cafe, watch the football match, bus journey home.

Resources: Money to cover the costs of bus fares, food and ticket.

	$	
Bus fares	1.50	2 x 75c
Food & drink	3.00	Burger and a soda
Tickets	3.00	Standing area
Sweets	0.50	To buy at the match
TOTAL	8.00	

Rudi's mother decides that the plan is a reasonable one but gives him \$8.00, not the \$10.00 he originally asked for.

The next day…….

On Saturday morning, Rudi's mother asks how he enjoyed the evening. He reports that the match was great, his team won and that he and his friends had a very entertaining evening even though it did not go entirely according to plan…After going to the cafe, Rudi and his friends arrived at the football stadium to find that all the $3.00 tickets were sold out and they had to spend an extra $1.00 each for a more expensive area.

This meant that Rudi did not have enough money left to buy sweets or to get the bus back home again. Fortunately, he met the parents of some school friends at the match and they offered to give him a lift home, which he gratefully accepted.

So it all ended well, even though his plans did not go *exactly* as intended.

Good Practice in Budgeting

- **Clarity**

Since many different people will need to use the budget for different purposes, they should be able to understand it (and adapt it, when necessary) without any additional explanation beyond what is written down.

Clarity and accuracy are essential so it is important to keep notes on budgeting assumptions and how calculations have been made.

- **Timetable**

There are several stages involved in constructing a budget before it can be submitted for approval to the governing body, so it is a good idea to prepare a budgeting timetable and commence the process early. This could be up to six months before the start of the financial year, depending on the size of the organisation and what approach has been adopted.

- **Budget Headings**

When setting a budget for the first time or when reviewing a budget, it is important to pay attention to the Chart of Accounts. This is because the budget line items also appear in the books of account and on management reports. If the budget items and accounting records are not consistent then it will be very difficult to produce monitoring reports once the project implementation stage is reached.

One way of achieving consistency is to design a Budget Preparation Sheet for your organisation, which will act as a memory-jogger and prompt staff to include all relevant costs. It will list all of the main types of income and expenditure that a project or department might have in a typical year.

Estimating Costs

It is important to be able to justify calculations when estimating costs. Even if you use the incremental method of budgeting, do not be tempted to simply take last year's budget and add a percentage amount on top for inflation. While last year's budget could be very helpful as a starting point, it could also be very misleading and contain historical inaccuracies.

One of the best approaches is to make a list of all the inputs required and specify the number and unit cost of each item. From this detailed working sheet, it is then a simple matter to produce a summarised budget for each line item and is very easy to update if units or costs change. **Table 3.1** below provides a simple example of the budget worksheet format.

See below for detailed guidance on how to use the Budget Worksheet and Appendix 12 for a completed project budget worksheet.

Contingencies

Try to avoid the practice of adding a 'bottom line' percentage for so-called 'contingencies' on the overall budget. As a rule, donors do not like to see this and it is not a very accurate way of calculating a budget. It is better to calculate and include a contingency amount for relevant items in the budget – eg salaries, insurance, and fuel.

Every item in your budget must be justifiable – adding a percentage on the bottom is difficult to justify – and difficult to monitor.

Forgotten costs

There is a tendency in the NGO world to under-estimate the true costs of running a project for fear of not getting the project funded.

Here are some of the most often overlooked costs:

- Staff related costs (eg recruitment costs, training, benefits and taxes)
- Start-up costs (eg publicity, legal costs)
- Overhead or core costs (eg insurance, utilities)
- Vehicle running costs
- Equipment maintenance and repairs (eg for photocopiers and computers)
- Governance costs (eg board meetings, AGM)
- Audit fees.

Using a Budget Worksheet

Table 3.1 shows a typical layout for a budget worksheet as used in activity-based and zero-based budgeting. The extract describes the inputs needed for a 4-day workshop for 20 participants with two tutors.

The table details items required for the workshop, the quantity and the cost per unit. The final column provides the budget for each item.

Table 3.1 Budget Worksheet

A	B	C	D	E	F	G [D x E x F]
Ref.	Description	Unit type	No. Unit	Quantity	Unit Cost $	Total cost $
1	**Workshop costs**					
1.1	Room hire for workshop	Days	4	1	25.00	100.00
1.2	Tutors' fees	Days	4	2	100.00	800.00
1.3	Tutors' accommodation	Nights	5	2	50.00	500.00
1.4	Lunch & refreshments	Delegate	22	4	5.00	440.00
1.5	Course handbooks	Delegate	22	1	5.00	110.00
1.6	Folders for papers	Trainee	20	1	3.00	60.00
	Sub total					**2010.00**

Other typical columns (not shown in the example above due to space limitations) include 'Notes' and 'Accounts Codes', as described in detail in **Table 3.2.**

Table 3.2: Budget Worksheet Columns

A	**Ref.**	Line reference – useful if you are discussing the budget and need to draw attention to a particular line in the budget worksheet. An activity-based budget is usually separated into sections, each with a sub total of costs. Each block will have a unique number, as in the above example where all 'workshop' related costs are listed under section 1.
B	**Description**	A short description of each line in the budget. Try to include different inputs on a line of their own rather than lump similar costs all together.
C	**Unit type**	This is the basis for the costing and calculations. The unit type will vary according to the budget item. For example, in line 1.4 of the table above, the budget for lunches is being costed on a per delegate basis. See below for some further examples of unit types to use for different budget items
D	**No. units**	This specifies the number of units required for the project. For example, in the budget above on line 1.4, we need lunches for 22 delegates (20 trainees plus 2 facilitators).
E	**Quantity**	This is useful where multiple items are required. For example, in line 1.4 in the table above, we need to provide lunches for 22 delegates on 4 days as it is a 4-day course. In line 1.3, we need to provide accommodation for 2 tutors. Whereas in line 1.1 we only need to hire one room.

F	**Unit cost**	That is, what does each unit cost as defined in column C? So, in line 1.4 we see that it costs $5.00 for lunch and refreshments for each delegate.
G	**Total cost**	This is calculated by multiplying no. units x quantity x unit cost. So, the cost of lunch and refreshments for 22 delegates on each of 4 days at $5.00 per delegate costs $440.00 [22 x 4 x 5]
H	**Notes**	A notes or comments column is useful to clarify what the item is for and how quantities have been arrived at.
I	**Accounts Code**	The code used in the organisation's accounting records (ie as listed in the Chart of Accounts)
J	**Donor code**	It is very useful to add another column which details the donor code or line item reference as this makes it easy to transfer the budget figures into the donor budget and reporting formats.

More on Unit Types

Deciding on the unit type requires some careful thought as it is not always so obvious and it does depend on how the items are usually sold or priced. See next page for a checklist to help you choose a unit type.

Summary: What makes a good budget?

The sign of a good budget is that anyone could pick it up and use it to manage their activities. It must:

- Be suitable for the purpose
- Have the right level of detail for the user
- Be easy to read
- Have clear calculations
- Include all costs which are justified and accurate
- Provide explanatory notes.

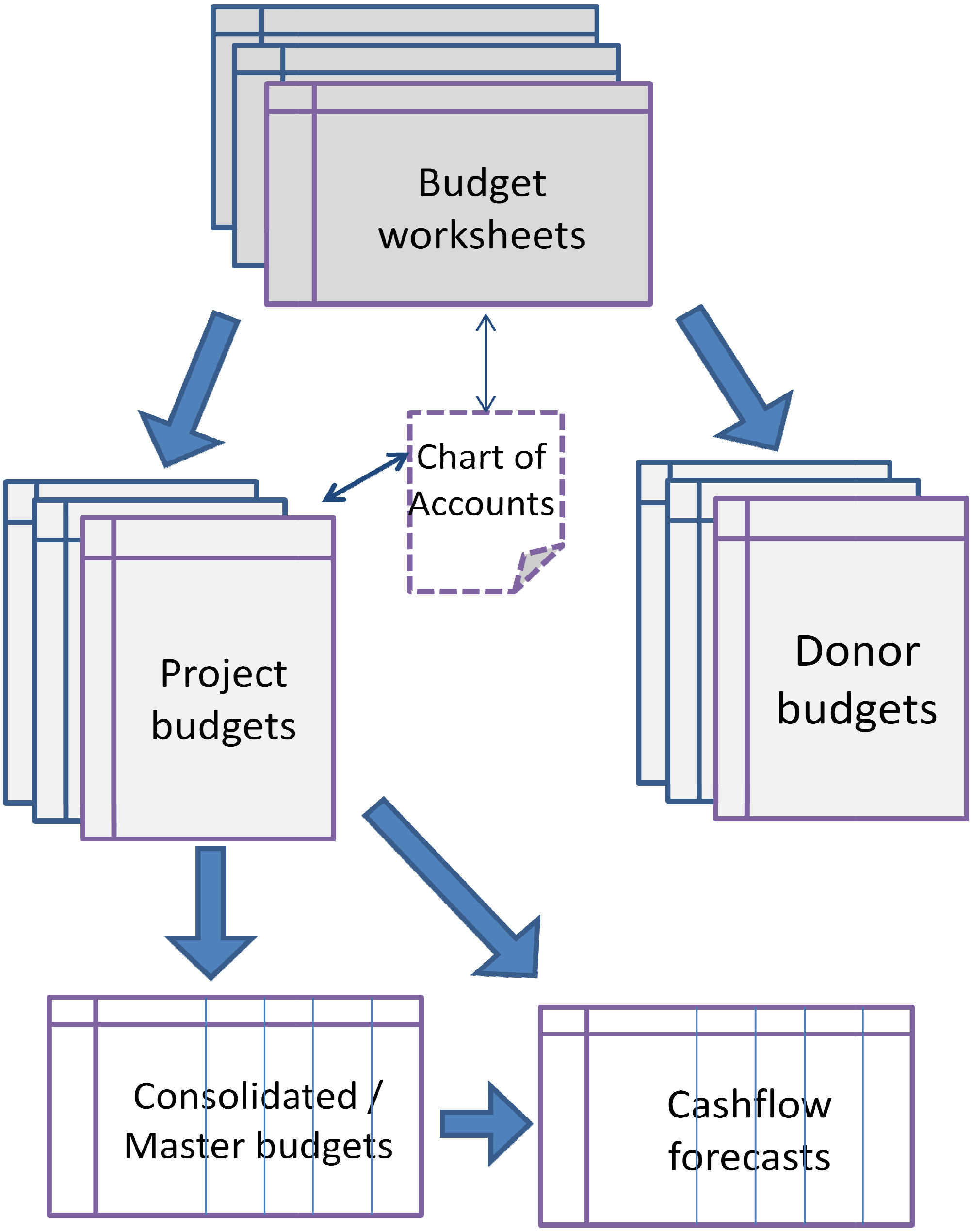
Table 3.3: Choosing Unit Types

Typical Budget Items:	Examples of Unit Type:
Personnel Costs	
Salaries, benefits & taxes	Month
Staff recruitment	Advert entry
Staff development	Days, person
Subsistence allowances (eg per diem)	Days, person, trip
Volunteers expenses	Session, person, trip
Transport costs	
Fuel & lubricants	Kilometre, month
Vehicle insurance	Month or lump sum per quotation
Vehicle maintenance	Kilometre, month
Air fares	Trip/journey
Bus/taxi fares	Trip, month
Distribution costs	Kilometre, trip, month
Programme administration	
Office rent, electricity and water	Month
Office insurance	Month or lump sum per quotation
Telephone & fax	Month
Office stationery	Month (or specify items, eg paper by the box, pens by the piece)
Email subscription	Month or lump sum per quotation
Postage	Month
Repairs & renewals	Month
Bank charges	Month
Audit fees	Lump sum per quotation
Project Costs	
Room hire	Days, month
Publicity costs	advert entry, lump sum per quotation (eg
Publications/reference books	Month or lump sum per quotation
Training materials	Trainee, or specify per item
Professional fees (eg facilitator, consultant)	Days
Printing/photocopy	Copy, delegate, lump sum per quotation
Inputs (eg trees, pipes, tents, tools, cattle)	Piece, according to charging basis
Equipment (eg vehicle, computer, desk etc.)	Piece, according to charging basis or lump sum per quotation
Accommodation	Night
Food	Person, meal, day

Consolidation Process

The diagram below demonstrates the process of consolidating budgets into various different formats and levels of summarisation. The key is to start with detailed budget worksheets which can then be turned into any format required.

Figure 3.4: Consolidating budgets



The Challenge of Core Costs

It is important to have a clearly stated policy on how your organisation will cover its core costs. These costs have to be funded just like any other cost incurred in an NGO.

The starting point is to produce a separate budget for core costs so they do not get overlooked or ignored.

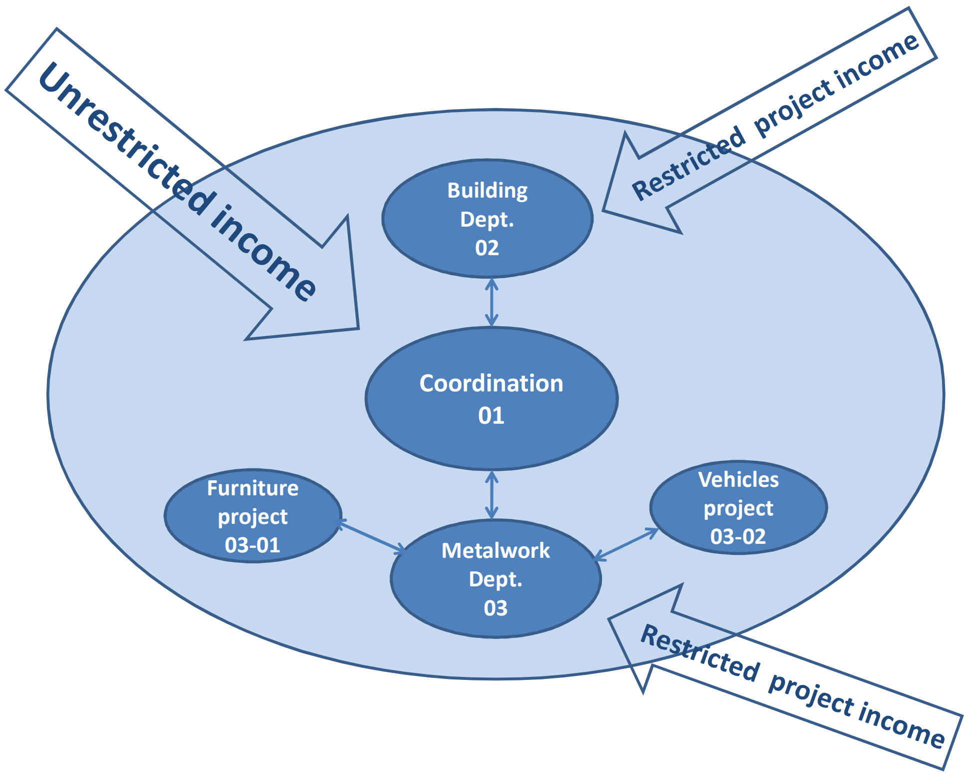
There are essentially two ways – or a combination of both – to fund your core costs:

- Use unrestricted funds (ie money given to the organisation for general purposes) to cover all or part of core costs; or
- Charge core costs out to projects using a pre-arranged apportioning ratio.

The diagram below shows how this works in practice for Milestone. Their restricted funds come in and get recorded at project level; unrestricted funds come in centrally are used to help pay for some of the core costs. Some project funds are also used to contribute to the core costs of the Coordination Department.

The methods which can be used to charge out core costs to projects are covered in a later chapter.

Figure 3.5: Financing Milestone's Core Costs



The Challenge of Multiple Donor Programmes

When a programme or project has more than one donor, it can present a number of financial planning problems. In particular,

- Donors have different budget formats and layouts, which they require you to use when applying for funds.
- Budget line items and descriptions vary, so it is not clear exactly what each category includes or excludes, eg 'Transportation' vs. 'Travel' vs. 'Vehicle Running costs'
- It is not always clear who is paying for what activity or item.
- Different donors have different policies on core costs. It is not always clear if all the core costs are covered.
- Sometimes double funding occurs for certain budget items whilst other items are under-funded.

Some Solutions

A carefully designed and detailed Chart of Accounts

If the Chart of Accounts is detailed enough, it will be able to cope with different donor budget formats. For example, the category 'Transportation' in an NGO's Chart of Accounts is extended to:

- Fuel & Lubricants
- Vehicle Maintenance
- Vehicle Insurance
- Public transport
- Air travel
- Distribution costs…etc

Use the budget worksheet approach to cost all projects

Because this approach provides a very detailed budget it is possible to transfer the information to any other budget formats as required. The level of detail provides maximum flexibility.

Include some 'indirect costs' as direct project costs in project budgets

Include as many project costs as possible in the project budget, including a share of the indirect project costs, such as office rent or a percentage of the Director's salary.

Take care: all costs must be justifiable.

Prepare a 'funding grid'

A funding grid is a special table which provides an overview of which donor fund is paying for what part of a budget.

It is an internal planning tool which should be updated regularly as new information becomes available. It is also useful for re-negotiating funding agreements and identifying fundraising needs.

How it works:

- The overall project or programme budget is detailed in column 1.
- Donor budgets are entered in the next columns and reconciled to the overall project or programme budget.
- Unrestricted funds are then entered to 'plug the gaps'.
- The final column identifies any double funding and remaining funding gaps.

Table 3.4 Example Funding Grid –Milestone Project (extract)

		Milestone's Confirmed Funding					
		RESTRICTED FUNDS			UNREST'D FUNDS		
Budget item	Total Budget	DFID	Smile Trust	Vanguard	General donations	Total expected funds	Surplus/ (deficit)
	USD	*USD*	*USD*	*USD*	*USD*	*USD*	*USD*
Admin.	38,100	9,000	9,000	0	13,200	31,200	(6,900)
Staff	71,000	18,000	18,000	9,000	26,000	71,000	0
Travel	51,000	11,000	11,000	2,000	6,500	30,500	(20,500)
Training	111,200	52,000	52,000	10,000	0	114,000	**2,800**
TOTAL	271,300	90,000	90,000	21,000	45,700	246,700	(24,600)

In the example above, we can see that:

- there are some predicted funding gaps for the Admin and Travel budget lines (indicated by the negative figures in brackets);
- a predicted surplus of funds on the Training budget line of USD 2,800 (indicated by the positive figure); and
- overall, Milestone *appears* to be USD 24,600 short of the funds it needs.

However, Milestone must not assume that it can keep the 'extra' USD 2,800 on the Training line and use it elsewhere in the budget: these funds are restricted and – strictly speaking – this presents a 'double funding' situation.

In this case, Milestone must contact the donor(s) and make a request to re-allocate the surplus funds on the Training line to other budget lines where there are funding gaps. If the donors refuse, the surplus restricted funds must be given back to the donor.

Chapter 4

Understanding Accounts

An Introduction to the Mysteries of Accounting Concepts and Jargon

This chapter:

- Discusses why an NGO needs to keep accounts
- Describes the different methods used to keep track of financial transactions
- Outlines which accounting records to keep
- Defines and explains key financial accounting concepts and terminology.
- Describes the financial statements which are prepared from the accounts.

Why Keep Accounts?

Good financial records are the basis for sound financial management of your organisation:

- **Information**

All organisations need to keep records of their financial transactions so that they can access information about their financial position, including:

- A summary of **Income and Expenditure** and how these are allocated under various categories.
- The **outcome** of all operations – surplus or deficit, net income or net expenditure.
- **Assets and Liabilities** – or what the organisation owns and owes to others.

- **Credibility**

NGOs especially need to be seen to be scrupulous in their handling of money – keeping accurate financial records promotes integrity, accountability and transparency and avoids suspicion of dishonesty.

- **Legal requirement**

There is often a statutory obligation to keep and publish accounts and donor agencies almost always require audited accounts as a condition of grant aid.

- **Future planning**

Although financial accounting information is historical (ie happened in the past), it will help managers to plan for the future and understand more about the operations of the NGO. With information spanning two or three years, it is possible to detect trends.

Accounting Methods

Keeping accounts simply means devising appropriate methods for storing financial information so that the organisation can show how it has spent its money and where the funds came from. Accounting records can be kept in a manual format – ie hardback books of account – or in a computerised format in one of many accounts packages available.

There are two main methods for keeping accounts:

- ✓ Cash accounting
- ✓ Accruals accounting

The two methods differ in a number of ways but the crucial difference is in how they deal with the timing of the two types of financial transaction:

- **Cash transactions** which have no time delay since the trading and exchange of monies takes place simultaneously.
- **Credit transactions** which involve a time lag between the contract and payment of money for the goods or services.

Significantly, the method we choose to record transactions will produce different financial information – as managers we need to know the basis of accounting to better understand financial reports.

- **Cash Accounting**

This is the simplest way to keep accounting records and does not require advanced bookkeeping skills to maintain. The main features are:

- Payment transactions are recorded in a Bank (or Cash) Book as and when they are made and incoming transactions as and when received.
- The system takes no account of time lags and any bills which might be outstanding.
- The system does not automatically maintain a record of any money owed by (liabilities) or to (assets) the organisation.
- The system cannot record *non-cash* transactions such as a donation in kind or depreciation.

When summarised, the records produce a *Receipts and Payments Account* for a given period. This simply shows the movement of cash in and out of the organisation and the cash balances at any given time.

See Appendix 7 for a sample Receipts and Payments Account.

■ Accruals Accounting

This involves '*double entry*' bookkeeping which refers to the dual aspects of recording financial transactions to recognise that there are always two parties involved: the giver and the receiver. The dual aspects are referred to as debits and credits. This system is more advanced and requires accountancy skills to maintain.

- Expenses are recorded in a *General Ledger* as they are incurred, rather than when the bill is actually paid; and when income is truly earned (ie we are 100% certain it will be paid) rather than when received.
- By recognising financial obligations when they occur, not when they are paid or received, this overcomes the problem of time lags, giving a truer picture of the financial position.
- The system can deal with all types of transactions and adjustments.
- The system automatically builds in up-to-date information on assets and liabilities.

These records provide an Income and Expenditure Account summarising all income and expenditure committed during a given period; and a Balance Sheet which demonstrates, amongst other things, moneys owed to and by the organisation on the last day of the period.

Table 4.1 Summary of differences between Cash and Accruals Accounting

	CASH	ACCRUALS
Accounting system	Single Entry	Double Entry
Transaction types	Cash only	Cash and Credit
Terminology	Receipts and Payments	Income and Expenditure
Main Book of Account	Bank (or Cash) Book	Nominal (or General) Ledger
Skill level	Basic bookkeeping	Advanced bookkeeping
Non-cash transactions	No	Yes
Assets & Liabilities	No	Yes
Reports produced	Receipts & Payments Report	Income & Expenditure Report with Balance Sheet

■ Hybrid Approach

Many NGOs adopt a 'half-way house' approach. They use the cash accounting basis during the year and then (often with the help of the auditor) convert the summarised figures at the year-end (or more frequently) to an accruals basis for the final accounts and audit.

This includes keeping separate books to record and identify accruals and prepayments (see examples below), unspent grants and capital purchases during the accounting period.

See Appendix 10 Note to the Accounts, Note 3 for a Schedule of Creditors and Debtors, identified for Milestone's year-end adjustment process.

Example of an Accrual

An electricity bill covering the last month of the financial year is not received until 4 weeks after the year-end. Even though the payment will be made during the new financial year, the expenditure must be recorded in the financial year that the electricity was consumed. It shows up as a liability on the Balance Sheet

Example of a Prepayment

Office rent is paid six months in advance. Half of the payment covers the first quarter of the new financial year and is therefore deducted from the office rent account for the current year at the year-end. It is carried forward to the rent account for the financial year when the rent falls due and shows up as a prepayment on the assets list in the Balance Sheet.

Which Accounting Records to Keep

For a small NGO with very few financial transactions, a simple bookkeeping system is all that is needed. As an organisation grows and takes on a number of projects and different sources of funding, its reporting requirements, and therefore its financial systems, will become more sophisticated.

Accounting records fall into two main categories:

- ✓ Supporting Documents
- ✓ Books of Account

■ Supporting documents

Every organisation should keep files of the following original documents to support every transaction taking place:

- Receipt or voucher for money received
- Receipt or voucher for money paid out
- Invoices – certified and stamped as paid

- Bank paying-in vouchers stamped and dated when money is taken to the bank
- Bank statements
- Journal vouchers – for one-off adjustments and non-cash transactions.

With these documents on file it will always be possible to construct a set of accounts. Other useful supporting documents include:

- Payment Vouchers (PVs)
- Local Purchase Orders (LPOs)
- Goods Received Notes (GRNs)

Books of account

The minimum requirements for books of account are:

- Bank (or Cash) Book for each bank account
- Petty Cash Book

For organisations with salaried staff, valuable equipment and significant levels of stock, the following records, where relevant, may also be kept as part of a full bookkeeping system:

- General/Nominal Ledger
- Journal or Day Book
- Wages book
- Assets Register
- Stock Control Book

Supporting Documentation

It is very important to maintain supporting documents in the form of receipts and vouchers for all financial transactions. These should be cross-referenced to the books of account and filed in date or number order.

RECEIPTS EXPLAIN:

- When?
- How Much?
- What?
- Who?
- Why?

Apart from being required by the external auditor to support the *audit trail*, certified receipts also provide protection to those handling the money. Mislaid or incomplete records can result in suspicion of mismanagement of funds.

Keep separate files for receipts for money coming into the organisation and money going out. Mark invoices ‘paid’ with the date and cheque number to prevent their fraudulent re-use by an unscrupulous person. Well maintained files provide invaluable information to the organisation such as the trends in price increases, details of equipment purchased, past discounts, etc.

Bank Book Basics

The Bank Book – or Cash Book or Cash Analysis Book – is the main book of account for recording bank transactions (ie 'cash' transactions). It is normal to maintain a separate Bank Book for each bank account held as this makes it easier to reconcile each account at the end of the month. [See Appendices 3 and 4 for a sample Bank Book.]

With a manual (paper based) Bank Book, receipts are usually entered on the left side and payments on the right and each page is ruled into columns (see Figure 4.1 for a typical layout). The number of columns required will depend on the type and volume of transactions.

Each transaction is entered on one line of either the Receipts page or the Payments page in date order. The column headings prompt you to enter key information – eg date, cheque number, payee, description, amount, category of transaction, etc. The columns are totalled at the end of each page or accounting period.

Analysis columns

These are what make the Bank Book such a useful record. These columns (numbered 1 to 9 in **Figure 4**.1) include the main categories of income and expenditure as identified in your Chart of Accounts and your budget. They allow you to sort and summarise transactions by budget category which in turn helps to compile financial reports quickly and easily.

Figure 4.1: Typical Bank Book layout

LEFT SIDE *Receipts of money into the bank*										**RIGHT SIDE** *Payments out of the bank*									
Date/details	1	2	3	4	5	6	7	8	9	Date/details	1	2	3	4	5	6	7	8	9

Bank Reconciliation

The Bank Book should be checked with the bank's records – the bank statement – at least once a month. This is called the *bank reconciliation*. The purpose of this process is to make sure that the organisation's own records agree with the bank's records and to pick up any errors made by the bank or the organisation.

A bank reconciliation involves taking the *closing bank statement balance* for a particular date and comparing it to the *closing Bank Book balance* for the same date. If there is a difference between these two closing balance figures, the difference must then be explained.

In practice, there will almost always be a difference because of timing delays, such as:

- Money paid into the bank which is not yet showing in the bank's records
- Cheques issued to a supplier but not yet banked by the supplier
- Bank charges and bank interest which get added to the bank statement by the bank periodically
- Errors either made by the bank or when recording entries in the Bank Book.

See Appendix 6 for a completed bank reconciliation form and Appendix 21 for a blank form to help you with this process.

Figure 4.2 below summarises the reconciliation process and actions to take when discrepancies are discovered.

Figure 4.2 Bank Reconciliation

Item:	In Cash Book	On Bank Statement	Example	Action
Receipt	✓	✗	Cash received in the office, but not yet banked. Cash fraud?	👓 Monitor bank statement (all cash received must be banked)
Receipt	✗	✓	Bank interest received Donor grant transferred, no advice note sent	📖 Enter into the Cashbook
Payment	✓	✗	Cheque sent to supplier, not presented to the bank	👓 Monitor bank statement ☎ Contact supplier if older than two months
Payment	✗	✓	Bank charges or bank interest paid	📖 Enter into the Cashbook
Cash Book Error	✓	✗	Omission or duplication of a transaction Figures entered incorrectly	📖 Correct the Cashbook
Bank Statement Error	✗	✓	Bank recording error Cheque fraud	☎ Contact the bank

Petty Cash Book

Petty cash records are kept in a similar way to the Bank Book records. As both sets of figures will eventually have to be combined to produce financial reports, it makes sense to set out the books in a consistent manner. A sample Petty Cash book can be seen in Appendix 5.

The Petty Cash Book can either be kept in a loose leaf or bound book format. It does not however, require more than one analysis column on the Receipts side because the only money that is paid into petty cash is the float reimbursement. The Petty Cash Book will also require fewer analysis columns for payments because petty cash will not (usually) be used to pay for larger items such as salaries, office rent, etc.

There are two ways of keeping petty cash:

- ✓ fixed float or *imprest* system
- ✓ variable or non-imprest system.

■ Fixed Float or Imprest Method

With the *imprest* system you have a fixed float of, say, $50 and when the cash balance gets low, you top up the float by exactly the same amount that you have spent since the float was last reimbursed.

Example:

Receipts/vouchers for cash spent total:	$34.60
Cash remaining in cash box counted::	$15.40
TOTAL FLOAT:	**$50.00**
∴ Reimbursement cheque written for:	$34.60

An advantage of this system is that at any time you count the money plus vouchers in the tin, they should always add up to the fixed float amount. Also, it is much easier to incorporate petty cash spending into the accounts as the reimbursement cheque is entered in the analysed Bank Book. See how the reimbursement cheque for the petty cash book in Appendix 5 has been written in to the Bank Book in Appendix 4. Look for cheque no. 13583 on 12/01.

■ Variable float or non-imprest method

An alternative is to draw cash from the bank in round sums as required.

If you use the non-imprest method you will need an extra column in your Bank Book headed 'petty cash withdrawn'. When reconciling this float you will have to add up all the petty cash withdrawals since the last reconciliation and add on the cash balance brought forward to get a total of the cash float for the period. This total should then be the same as the total spent since the last reconciliation plus the cash left in the tin. A more complicated and time consuming process!

Full Bookkeeping Systems

Organisations requiring a full bookkeeping system use a series of *ledgers* (this just means books of account), depending on the activities of the organisation.

■ The General or Nominal Ledger

This is a central record which pulls together basic bookkeeping information from the main working books of account (Bank Book, Petty Cash Book, Sales and Purchase Ledgers). It is like a series of 'pigeonholes' used to sort basic financial information and is especially useful when an organisation has several projects and different donors requiring different reports.

The General (or Nominal) Ledger has one page for each category of income, expenditure, assets and liabilities and information is 'posted' from the other accounting books into each pigeonhole. It plays a central role in the double-entry bookkeeping system and is the basis for the Trial Balance (see below), the starting point for preparation of financial statements.

■ Other Ledgers

Other elements in a full-bookkeeping system include:

- Sales ledger and sales day book (but only if you have sales)
- Purchase ledger and purchase day book
- Stock ledger
- Journal

These, together with the Bank Book and Petty Cash Book are the day-to-day working accounts books. It is quite possible to set up a General Ledger without these additional ledgers; the choice will depend on the activities of your organisation.

The **Journal** is used to record unusual, one-off transactions which cannot be recorded easily in other books of accounts. These will include non-cash transactions (such as *depreciation* and donations-in-kind), adjustments and corrections.

A *journal entry* follows the rules of double entry and will always include entries to at least two accounts. For example, a donation-in-kind in the form of rent-free office space would be recorded as income under 'Donations' and expenditure under 'Office Rent'.

■ Wages Records

Employers have a statutory duty to maintain records of all wages paid and deductions made and failure to do so could result in a heavy fine. Be sure to familiarise yourselves with the arrangements of your own Department of Taxes and get hold of the latest tax deduction tables.

Larger organisations should also keep a separate Wages Book, which brings together all information on staff salaries and deductions. These can be purchased from stationery suppliers in a pre-printed format and they help to facilitate the year-end reconciliation or available as add-ons to accounting software packages.

What is a Trial Balance?

The *Trial Balance* (or what accountants often refer to as the 'TB') is simply an arithmetical check on the accounts maintained using the Double Entry method of accounting. It is also the basis for the preparation of accruals-based financial statements.

At the end of an accounting period – usually monthly – all the accounts categories having a balance in the General Ledger are listed on a summary sheet to form a Trial Balance. Providing no errors have crept in during the recording and summarising stages, the total of debit balances on the list will equal the total of the credit balances.

Figure 4.3 below illustrates which figures from the Trial Balance end up where in the annual financial statements.

Figure 4.3: Trial Balance leading to financial statements

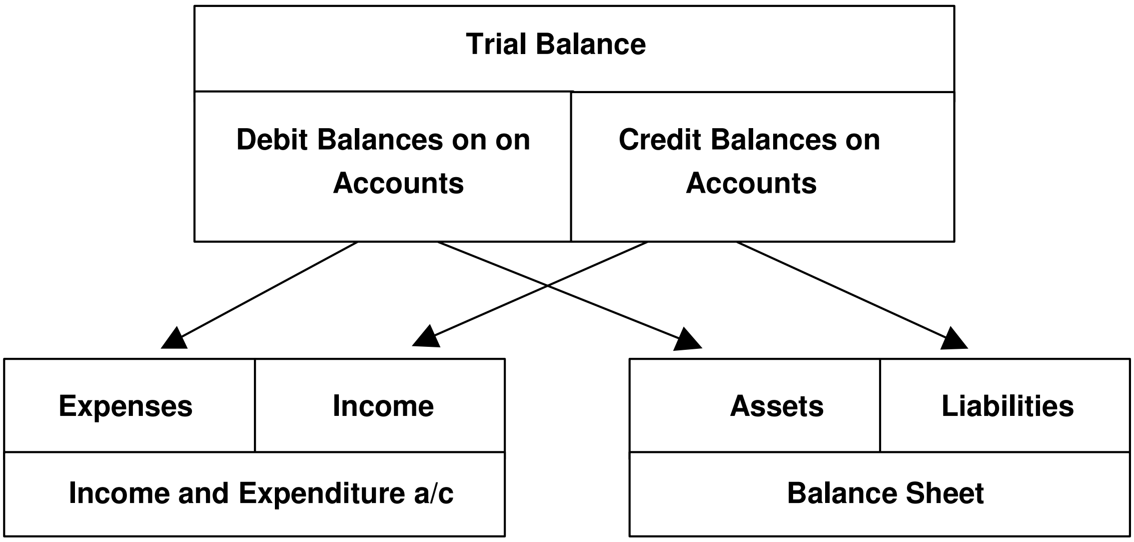
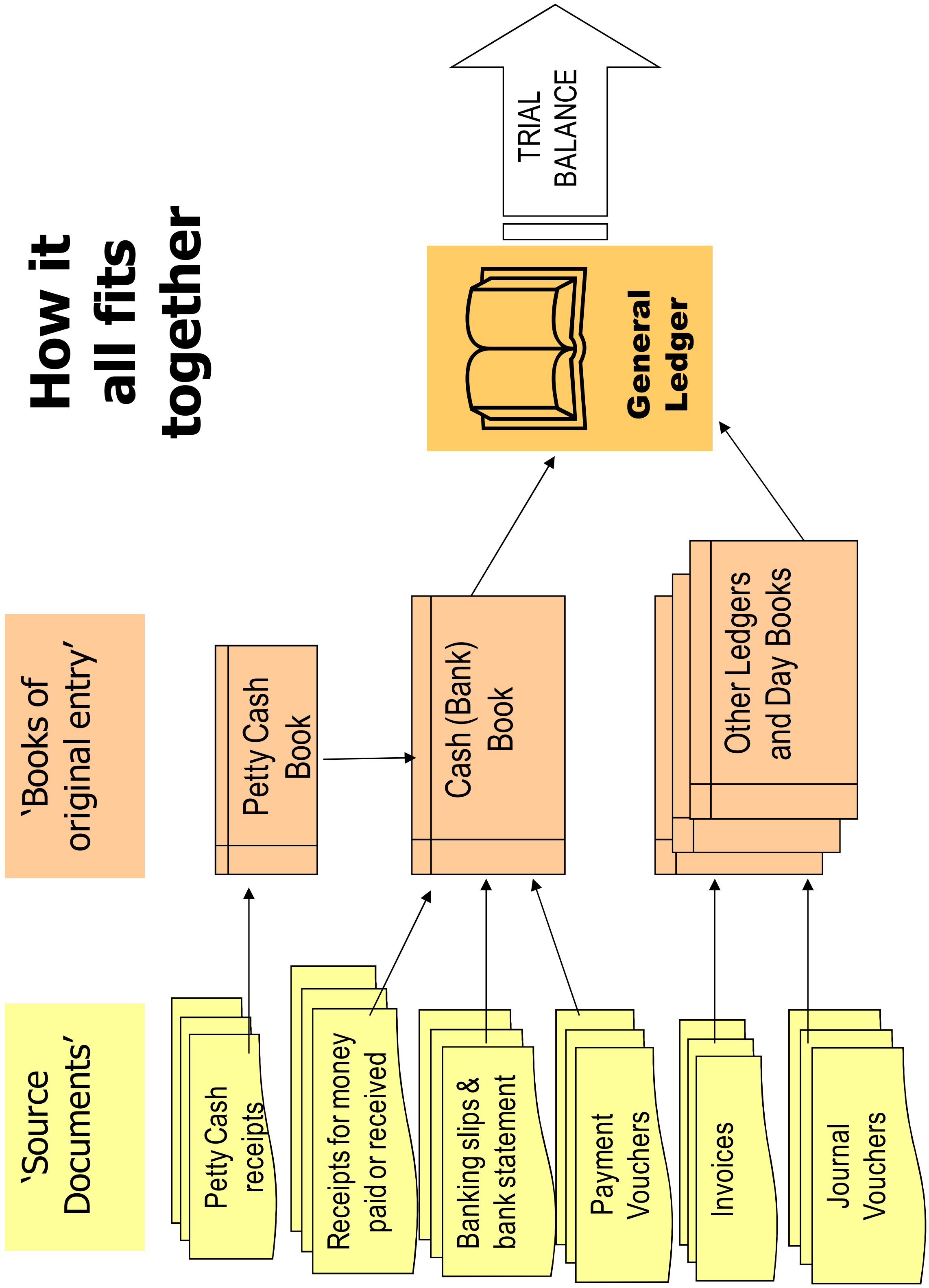


Figure 4.4 shows how the Trial Balance is the final stage of the accounting process – the result of recording, classifying and summarising the many different transactions that take place in an organisation.

Figure 4.3: How it all fits together



What are Financial Statements?

Financial statements are a product of the financial accounting process. They are a summary of all the transactions for a specified period and show the financial position of an organisation.

Financial statements can cover any period of time – for example, a month, a quarter or one year. The annual financial statements are used as the basis for an annual external audit.

The simplest of all financial statements is the Receipts and Payments report. This is a summary of the Cashbook (see Appendix 7) and includes details of cash balances at the start and end of the reporting period.

The other two main reports relevant to NGOs are:

- ✓ The Income and Expenditure report
- ✓ The Balance Sheet.

Together these contain a lot of useful information. In the chapter on Financial Reports, we look at how to analyse the information in the financial statements.

The Income and Expenditure Report

In the not-for-profit sector, the equivalent of the Profit and Loss Account is the Income and Expenditure Report (or Account). See Appendix 8 for an example.

It is either produced from a *Trial Balance* (as described above) where the accruals-based system of accounting is used; or it is based on a Receipts and Payments account with adjustments for 'loose ends'.

It records as a summary:

- all categories of income and expenditure which belong to that year;
- all income not yet received but belonging to that financial year; and
- all payments not yet paid but belonging to that financial year.

Income items usually appear first in a list down the page, followed by the summary of expenditure items. The difference between total income and total expenditure, often called the *outcome*, appears on the bottom line and is expressed either as:

- 'excess of income over expenditure' where there is a surplus; or
- 'excess of expenditure over income' where there is a deficit.

This excess figure is then included on the Balance Sheet under the heading Accumulated Funds. Note that there should be an accompanying Balance Sheet for the same date that the Income and Expenditure Account is prepared at.

The Balance Sheet

The purpose of a Balance Sheet is to assess the financial position – or 'net worth' – of an organisation at a given date. If the organisation ceased operating at that date and all of its assets were converted into cash, and all of its debts were paid off, then what was left over would be what the organisation was 'worth'. See Appendix 9.

> *The balance sheet is a list of all the assets and liabilities on* **one particular date** *and provides a 'snapshot' of the financial position of an organisation.*

■ Components of a Balance Sheet

The Balance Sheet is in two parts. One part records all balances on **assets** accounts; the other records all balances on **liabilities** accounts plus the income and expenditure account balance. The Balance Sheet will either be presented with the Assets listed on the left and the Liabilities presented on the right of the page, or more commonly nowadays, listed down the page with Assets presented first then Liabilities deducted from them.

Fixed assets

These are the tangible, long-term, assets such as buildings, equipment and vehicles, having a value lasting more than one year. Fixed assets are shown on the balance sheet after an allowance for wear and tear – or *depreciation* – has been made (see an explanation of what depreciation is later in this chapter).

Current assets

These are the more 'liquid' assets such as cash in the bank, payments made in advance and stocks. These, in theory at least, can be converted into cash within 12 months.

Liabilities are also divided into current liabilities and long-term liabilities.

- **Current** or **short term** liabilities – including outstanding payments, and short-term borrowings – ie those having to be paid within 12 months.
- **Long-term** liabilities such as loans that need to be paid after 12 months. (However, for NGOs such borrowings are not common.)

Accumulated Funds

Accumulated Funds and Reserves are separated out from other liabilities and act as a balancing item on the Balance sheet. They represent the true worth of the organisation – in the form of capital and/or cash reserves which have been built up from surpluses in previous years. Accumulated Funds are classified as liabilities since, in an NGO, the funds are held in trust for the organisation in pursuance of its objectives.

Liquidity

The term liquidity is used to describe how easy or otherwise assets can be turned into cash. So money held in a bank account is deemed to be very liquid, while money tied up in a building is clearly not liquid at all.

Working capital

This is the same as *net current assets,* that is, the short-term assets remaining if all immediate debts were paid off. These are the funds that the organisation has available as a cushion or safety net for running the organisation's operations.

The table below summarises the main components and typical layout of a balance sheet, although note that terminology does vary.

Table 4.2 Components of a Balance Sheet

Component:	**Description:**
FIXED ASSETS:	The less liquid assets – those having a significant value lasting more than one year.
CURRENT ASSETS:	The more liquid assets – can usually be converted into cash within one year.
- Cash	Funds held in the bank and as cash.
- Debtors	Money owed to the organisation such as loans and unpaid sales invoices.
- Prepayments	Value of items paid for in advance such as insurance premiums or equipment rental.
- Grants Due	Grants owed to the organisation for projects already started in the reporting period.
- Stocks	The value of raw materials or supplies such as publications or T-shirts for sale.
CURRENT LIABILITIES:	Those paid within one year of the year-end.
- Creditors & Accruals	Money owed by the organisation at the year-end such as bank overdrafts, unpaid bills.
- Grants in Advance	Grants received for a particular purpose but not yet spent in full, so carried forward to the next financial year.
OTHER LIABILITIES:	Longer term commitments and General Funds.
- Reserves	Money set aside for specific purposes, eg replacing equipment. Although designated funds, they form part of the organisation's General Funds.
- Accumulated Funds	Accumulated surplus of income over expenditure achieved since the organisation opened.

What is Depreciation?

Capital expenditure, such as that on buildings, computer equipment and vehicles, is expenditure which covers more than one accounting period and retains some value to the organisation.

Depreciation is the way that accountants deal with the cost of wear and tear on fixed assets. It allows the original cost of the item to be spread over its 'useful life'.

The amount calculated for depreciation is shown as an expense in the accounts and deducted from the previous value of the asset. As it is a non-cash transaction, depreciation is entered in the accounts using a journal entry.

There are several methods used to calculate the cost of depreciating assets, but the two most commonly used are: Straight Line method and Reducing Balance method

In the **Straight Line method** the amount to be depreciated is spread evenly over a pre-arranged period. For example, a computer purchased for USD 1,000 expected to last for 4 years will be depreciated at USD 250 per year for 4 years. At the end of 4 years the computer will have a zero *net book value* – ie it will have no value as far as the accounts are concerned. In reality, it may have a second hand market value.

The Reducing Balance method fixes a percentage reduction in value so that the item loses more value in the earlier years.

Example:

A car is purchased for USD 10,000. It is decided to depreciate it over 4 years – ie by 25% per year. The table below shows how the equipment is depreciated over its useful life (all figures are rounded to nearest dollar).

Table 4.3: Depreciation schedule

Year	Depreciation calculation	Net Book Value
Year 1	\$10,000 x 25% = \$2,500	\$7,500
Year 2	\$7,500 x 25% = \$1,875	\$5,625
Year 3	\$5, 625 x 25% = \$1,406	\$4,219
Year 4	\$4,219 x 25% = \$1,055	\$3,164

Note that when using this method, the asset is never completely written off. At the end of the 4^{th} year it will still have a *residual value*. In this example, the car will be valued in the accounts at USD 3,164. This recognises that the item may have a resale value when it comes to replacing it.

Accounting for Shared Costs

Some costs cover more than one project or activity. In this case, it is important to identify which activities the costs should be charged to.

There are two types of shared costs:

- Those that are truly **direct costs** and belong to two or more projects
- Those that are truly **indirect costs** that must to be shared across all projects in the organisation.

For truly direct project costs – eg the cost of using a shared vehicle for project activities – these must be **allocated** according to actual use to the relevant project cost centre. It is best to make the allocation when the transaction is entered into the accounting records.

For truly indirect costs – ie central support costs such as the central office running costs or the annual audit fee – these must be **apportioned** in a fair and justifiable way across all cost centres.

Central support costs are often shared out between cost centres in a pre-arranged ratio. This is more commonly entered in the accounting records or at the end of the reporting period by making one adjustment entry.

The decision on how to apportion costs between cost centres can be based on different criteria according to what is known as the *cost driver*, for example:

- Full-time equivalent (FTE) staff
- Number of cost centres
- Size of each project budget
- Project staff costs
- Amount of space used by a department.

There is no hard and fast rule for apportioning central support costs to projects. It should however be logical, transparent and consistently applied.

Chapter 5

Financial Reports

Making Sense of the Numbers

Introduction

This chapter:

- Identifies the who, what, when and why of financial reporting
- Explains how to interpret financial statements using trend and ratio analysis
- Explains how to compile and use the information in management accounts
- Outlines the important features of donor reports
- Outlines reasons for reporting to our beneficiaries.

Who Needs Financial Reports?

As we have seen, one of the main reasons for keeping accounting records is so that information about how the organisation is being run can be obtained. Having set up accounting systems and budgets, the next step is to produce financial reports to report on and monitor the organisation's financial affairs.

Providing the accounts are kept in a suitable way and have been checked for accuracy, putting together a financial report is not as time-consuming as you might think.

> *Financial reports must be timely, accurate and relevant.*

Financial reports are needed primarily by those responsible for managing the organisation and by current and potential donor agencies; but those responsible for financial management of an NGO also need to 'give an account' of their stewardship to a wide range of stakeholders.

Table 5.1 summarises the main users of NGO reports and why they need this information.

Table 5.1: Who needs financial information?

Stakeholder	Why do they need it?
Project staff	To know how much money and resources are available for their projects and what has been spent so far.
Managers	To keep an eye on how project funds are being used, especially compared to the original plans. To help plan for the future.
Finance staff	To make sure that there is enough money in the bank to buy the things the NGO needs to run its programmes.
Board of Trustees	To keep an eye on how resources are being used to achieve the NGO's objectives.
Donors	To make sure that their grants are being used as agreed and that the project's objectives are being fulfilled. To consider whether to support an organisation in the future.
Government departments	To make sure that the NGO pays any taxes due and that it does not abuse it status as a 'not for profit' organisation.
Project beneficiaries	To know what it costs to provide the services they are benefiting from and to decide if this is good value for their community.
The general public	To know what the NGO raises and spends during the year and what the money is used for.

From this list, we can see that there are many different users of financial reports – both internal and external stakeholders – using financial information for management and accountability purposes. It is not surprising, therefore that we need different kinds of reports for different users, as summarised in **Table 5.2** below.

- During the financial year accounting information is summarised and turned into *Management Accounts* for internal monitoring of progress against the budget.
- At the end of the year, the *Annual Accounts* (ie the Balance Sheet and Income and Expenditure Account) are produced to report on the outcome to external stakeholders.
- At intervals during the year, an NGO will also be required to complete special *progress reports to donor agencies*.

Table 5.2: Different Reports for Different Users

	Programme management	Stakeholder accountability
Internal	Management Accounts: Budget Monitoring report and Cashflow report	Board report
External	Donor progress report (financial and narrative)	Donor report Audited Financial Statements Annual Report Reports to beneficiaries

What are the Annual Accounts?

We return to the Balance Sheet and Income and Expenditure Account. These annual financial statements show in summarised form:

- where money has come from;
- for what purpose it has been received;
- how it has been spent; and
- what the outcomes of operations are.

They should be prepared as soon as possible after the end of the financial year – for example within six weeks – and made ready for the external audit. The organisation's constitution will often specify the deadline for presentation of accounts to the members.

The Annual Accounts, accompanied by the Annual Report, form the main publicity and information package available and will be of interest to many users. For this reason, the annual accounts should:

- present the organisation in the best possible light;
- help to promote its work;
- meet the needs of those using the accounts; and
- meet the requirements of auditors.

If an NGO's annual accounts show large accumulated funds, it may give the impression that the organisation is well resourced and donors may be less inclined to give support to new initiatives.

There are however, good reasons why an organisation will have cash reserves – for example, funds put aside to replace equipment or a building appeal fund. An explanation must be provided to reassure potential donors that their support really is needed.

Interpreting Financial Statements

The aim when reviewing an NGO's financial reports is to assess the health of the organisation and to check that funds are being used as intended – ie to achieve organisation objectives.

Numbers taken on their own don't tell us very much. We need something to measure them against – such as comparing them to similar organisations, standard measures or targets, or previous years' accounts.

When we interpret the Balance Sheet and Income and Expenditure statement we use two types of financial analysis:

- **Trend analysis** which asks: How are we doing compared with the last period?
- **Ratio Analysis** which provides a means of interpreting and comparing financial results.

Trend Analysis

Trend analysis takes at least two sets of figures compiled using the same accounting techniques and showing information for two consecutive periods, usually year on year. By comparing the figures it may be possible to detect trends and use this information to forecast future trends or set targets.

Trend analysis is more meaningful if also combined with financial ratio analysis.

Financial Ratio Analysis

Financial *Ratio Analysis* is used widely in business to assess the profitability and efficiency of companies. Ratio analysis in the not-for-profit sector is less common, but is nonetheless very useful if adapted for the sector.

Ratios allow comparison of reports expressed in different currencies and between organisations of different scale by converting them into a like measure. Donor agencies often use this technique when assessing performance, especially to compare relative costs – such as central administration – between similar organisations or projects.

The importance of ratios is in the clues they may provide to what is going on, not as absolute measures of good or bad performance. Ratio analysis helps Board members and managers answer three important questions:

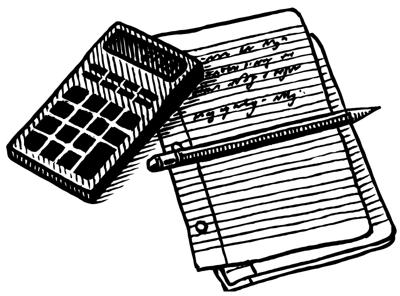
- **Financial sustainability** – will our organisation have the money it needs to continue serving people tomorrow as well as today?
- **Efficiency** – does our organisation serve as many people as possible with its resources for the lowest possible cost?
- **Effectiveness** – is our organisation doing a responsible job of managing its money?

Analysing the Income and Expenditure Account

You can use ratios on the Income and Expenditure report by converting each line item into a percentage of total income (that means to divide each item by total income and multiply by 100). This gives a guide as to the relative importance of different areas on the statement. For example, the relative costs of administration versus direct project costs. This is useful for drawing attention to the important areas and away from insignificant issues.

This calculation will also give an indication of the level of **donor dependency** – by dividing the total of donor grants by total income and multiply by 100. If your financing strategy is leading you towards less dependence on external aid, the dependency ratio will help to set and monitor your target level.

A further level of analysis can be obtained by comparing the ratios for the current and previous years' figures to detect trends.



Analysing the Balance Sheet

Again try dividing everything by the total income figure shown on the accompanying Income and Expenditure statement to give an indication of the relative importance of items on the Balance Sheet.

A **'Survival Ratio'** can be calculated by dividing general reserves , sometimes called 'free reserves' (that's the part of the Accumulated Funds which are unrestricted, not held as capital and for general use) by total income (from the accompanying Income and Expenditure statement).

If you then multiply the resulting figure by 365 this will give an indication, in days, of how long the organisation could survive in the coming year if income dried up and levels of activity remain the same. Of course, this is a highly hypothetical scenario as in practice the organisation would contract operations if its income was drastically reduce.

The **Acid Test** or Quick Ratio asks the question: *Can we pay off our debts now?* It divides Current Assets less the less 'liquid' assets such as stocks and prepayments (in other words, short term debtors and cash balances only) by Current Liabilities (short-term creditors and overdrafts). The resulting ratio should ideally be in the range of 1:1. A ratio of 1:1 suggests an organisation has sufficient cash to pay its immediate debts.

The **Current Ratio** asks the question: *Can we pay off our debts within 12 months?* It divides total Current Assets by total Current Liabilities to find a further test of an organisation's (longer term) liquidity. A result of 2:1 is considered satisfactory. Again, convert the figures for both years shown on the Balance Sheet to detect significant trends.

Ratio Analysis – Quick Reference Formulas

RATIO:	FORMULA:
1. **Donor Dependency:** Expressed as %	$\frac{\text{TOTAL DONOR INCOME}}{\text{TOTAL INCOME}} \times 100$
2. Income Utilisation: Expressed as %	$\frac{\text{EXPENDITURE ITEM}}{\text{TOTAL INCOME}} \times 100$
3. 'Survival Ratio': Expressed in weeks or days	$\frac{\text{GENERAL RESERVES*}}{\text{TOTAL INCOME}} \times 52$ or $\times 365$ * these are un-restricted funds for general purposes under Accumulated Funds. Alternatively use Net Current Assets.
4. Acid Test or Liquidity Ratio: Expressed as a ratio n:n*	$\frac{\text{CURRENT ASSETS – PREPAYMENTS}}{\text{CURRENT LIABILITIES}}$ *Answer should be in the range of 0.8 to 1.2:1. A result of 1 to 1 means there are sufficient funds to cover immediate debts.
5. Current Ratio: Expressed as a ratio n:n*	$\frac{\text{CURRENT ASSETS}}{\text{CURRENT LIABILITIES}}$ *A result of 2:1 is considered satisfactory – enough to pay off the debts within 12 months.

Management Reporting

Managers need financial information throughout the financial year to monitor project progress and manage budgets effectively. If reports are produced on a timely basis, any problems can be addressed early on and action taken to put things right.

■ How often?

Ideally, the management accounts should be produced every month and within a few days of the end of the accounting period (any later and the information becomes out of date and less useful). The minimum frequency for management reports is once a quarter.

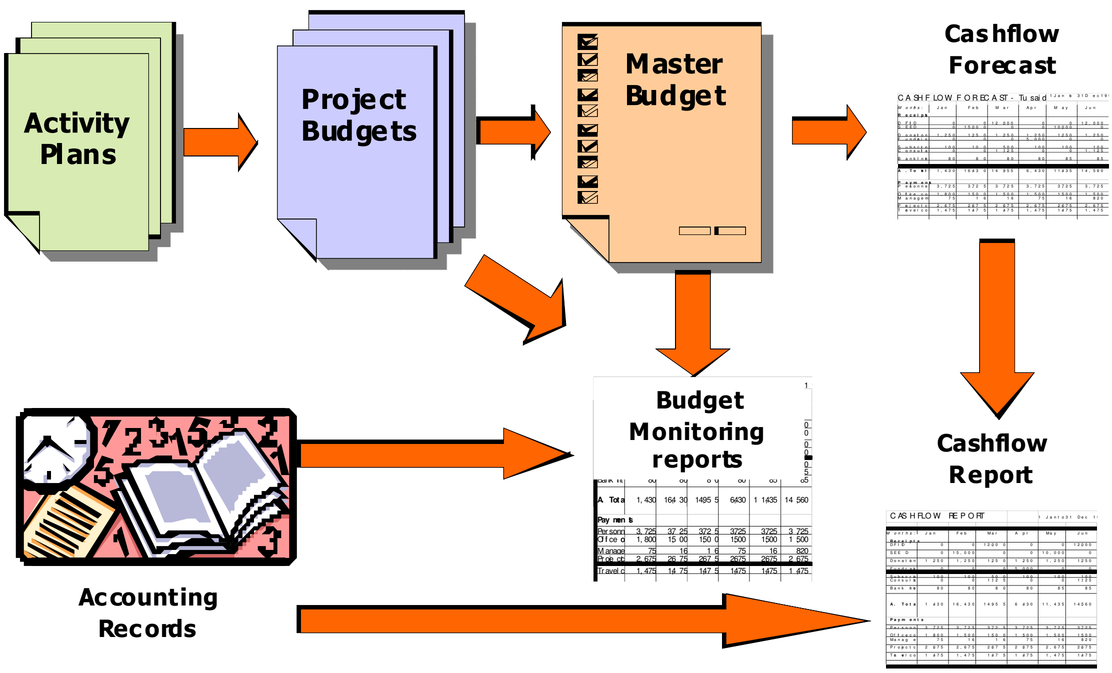
Since the reports are produced so that managers can take decisions about the future management of the organisation, the meetings of the governing body should be set to coincide with the Management Accounts cycle so that the information is still timely.

■ Where do the figures come from?

Figure 5.1 shows how the financial planning and financial accounting processes come together to produce management reports.

The reports are compiled by taking summarised figures from the main books of account and the budget for the same period. Providing the accounts and budgets have been set up to use the same Chart of Accounts codes and descriptions, this should be a very quick process and no additional work is required.

Figure 5.1: Management Reporting Flow Chart



- **Which reports?**

The main reports that will be useful to managers are the:

- Cashflow Report
- Budget Monitoring Report
- Forecast Report.

The Cashflow Report

The cashflow report is the cashflow forecast updated with actual receipts and payments each month, plus any new information about future spending or fund-raising plans. It allows managers to predict periods when cash balances are likely to be insufficient to meet commitments and make the most of any surplus funds during the year.

Where cash resources are limited, it is important to monitor for the ability to pay creditors on time and to take action when there are early warnings of potential financial difficulty. Options available for managing cashflow include:

- Exercise good credit control – chase debtors for prompt payment
- Review grant schedules– encourage payment in advance rather than in arrears
- Bank all monies received daily
- Request special payment terms from major suppliers (and stick to them)
- Pay certain overheads by instalment – eg insurance premiums
- Prioritise major payments
- Defer action that will lead to additional expenditure – eg recruitment, taking on leases, purchasing equipment
- Negotiate an overdraft facility as short term – but expensive – remedy.

The Budget Monitoring Report

This report has several different names (eg Budget Compared to Actual, Budget Variance and Budget Versus Actual) and can take different forms. But as the titles suggest, the reports take the *budget* for the reporting period (preferably the *phased* budget) and compares that with the *actual* income and expenditure for the same period. See a sample report in Appendix 14.

The difference between the budget and the actual result is known as the v*ariance* and this can tell us a lot about what is happening in a project. Variance figures will be positive negative or zero, depending on what has happened. Often, budget monitoring reports also show variances as percentages.

For example, the amount of the budget or grant used up so far is known as the budget or grant *utilisation ratio* or the *burn rate* (see below for how to calculate percentages.)

We can see the *Plan-Do-Review* process in action in Rudi's evening out. He set out his plans for the evening and what each activity would cost (*PLAN*) and then went out with his friends (*DO*). But it did not all go as planned and his actual spending varied as a result. If we look at the variance column in Rudi's Budget Compared to Actual Report (REVIEW) in **Table 5.3** it is possible to see the story behind the figures...

Table 5.3 Rudi's Budget Compared to Actual Report

A	B	C	D	E
Budget Item	Budget $	Actually Spent $	Variance $	Budget Utilisation %
Travel	1.50	0.75	0.75	50%
Food	3.50	3.00	0.50	86%
Entrance Fee	3.00	4.00	(1.00)	133%
TOTAL	**8.00**	**7.75**	**0.25**	**97%**

For example, we can see the effect of Rudi arriving too late to buy the cheaper match tickets: he spent USD 1.00 (or 33%) more than planned on the entrance fee. And because he then didn't have enough money left to buy his bus fare back home (he got a free lift home instead) he also under-spent on his Travel budget, using up only 50% of that line.

When we review the figures, and in particular the variance column, it helps us to understand why we did not fulfil the plans and build in that learning to the next cycle.

In Rudi's case, he learnt that he needs to get to the match earlier to buy a cheap ticket (and his mother learnt that it might be a good idea to give Rudi a bit extra for emergencies to make sure he gets home safely.)

■ How to Calculate Percentages

The budget variance percentage can be calculated in one of two ways. You may use either method but it is important to be consistent:

a. $\frac{\text{Budget variance \$}}{\text{Budget for } \textbf{period} \text{ \$}} \times 100$ — Under-spends will result in a positive % and over-spends will produce a negative %

b. $\frac{\text{Actual for period \$}}{\text{Budget for } \textbf{period} \text{ \$}} \times 100$ — Under-spends will result in a figure <u>less</u> than 100% and over-spends will be <u>more</u> than 100%

% Budget Utilised (or 'Burn Rate'):

$\frac{\text{Actual spend \$}}{\textbf{Total} \text{ Budget \$}} \times 100$ — A resulting figure of over 100% means the <u>total</u> project budget is overspent.

Forecast Reports

Forecast reports are especially helpful from the second quarter onwards for predicting the outcome for the year and helping with the budget process for the next year.

See Appendix 16 for a sample Budget Forecast report.

With a fair degree of accuracy you should be able to tell whether the organisation is going to run a surplus or deficit. This is all-important in your relationship with donors:

- A large deficit can make the organisation appear to be out of control and poorly managed
- A small deficit can demonstrate a great need and even a sense of good housekeeping
- A small surplus can suggest good management
- A large surplus can indicate a failure to meet needs or inexperience in budgeting.

There are various ways of reducing a surplus at year-end, including purchasing new or replacement equipment, ordering stocks of stationery and office supplies. There is very little that can be done about a large deficit except to provide an early warning and a very good explanation to stakeholders and hope that there are sufficient reserves to cover it.

Analysing Budget Monitoring Reports

Budget monitoring reports help to identify problem areas and provide an early warning when key targets are not being met. They may also help detect fraud and errors in the accounts.

■ What should we look for?

Here are some key areas to focus on when you pick up a Budget Monitoring Report:

- What is the **accounting basis** of the report – is it compiled on the cash or accruals basis? Are there outstanding commitments (see note below)? If so, how does that affect the results?

- What does the **bottom line** tell you? Overall, is the budget over-spending or under-spending and is it significant at this time in the life of the project tor program me? An outcome of plus or minus 10% from the budget is considered to be a reasonable variance.
- What is the result within budget **'family groups'** (ie budget items in the same area, such as Staff costs, Project inputs, Admin costs etc)? Is spending overall on target across the group? Again, if the result is within plus or minus 10% from the budget, that is generally acceptable.
- Look for unusual or **unexpected results** - could this be an indication of a mis-coding or abuse?
- Are there any **significant variances** in the individual line items? Are the reasons for the differences explained? For example, the Subsistence Expenses budget is substantially and unexpectedly over-spent. Do not just concentrate on over-spending – remember that under-spending is just as critical for an NGO.
- Do **linked budget line items** (eg activity-related costs) tell the same story or do they contradict? For example, the project materials budget is under-spent suggesting delayed activities but the vehicle running costs are high, which is not logical.
- Do the budget report figures tell the same story as the **narrative** project report?

> *Sometimes the figures just do not look right: so trust your instincts and follow up your concerns.*

A note on Commitments

Commitments refer to (significant) expenses which have been incurred for a project or organisation in a particular period but haven't yet been accounted for or belong to a future reporting period. Commitments usually occur in a cash accounting system or where there are time delays in reporting all expenditure, eg from field offices.

If significant commitments are not taken into account when compiling budget monitoring reports, the results may under- or over-count the true level of expenditure and give a distorted view when compared to the budget.

It is important to be aware of outstanding commitments when monitoring a budget or grant because decisions are based on the reported variances and balances available. It could appear that there is more (or less) money available to spend than there really is.

Here are two solutions if figures exclude outstanding commitments:

- Include an extra column in the budget monitoring report to record known commitments
- Add a note about known commitments in the comments column or covering note.

Variance Analysis techniques

Variance analysis involves looking at variations from budget to identify significant or unusual variances and what has caused them to happen. This helps us plan the next phase.

The first task is to identify whether the variance is a positive or negative one. Positive variances are sometimes described as *favourable* (ie generally good news) and negative ones as *adverse* (ie generally bad news):

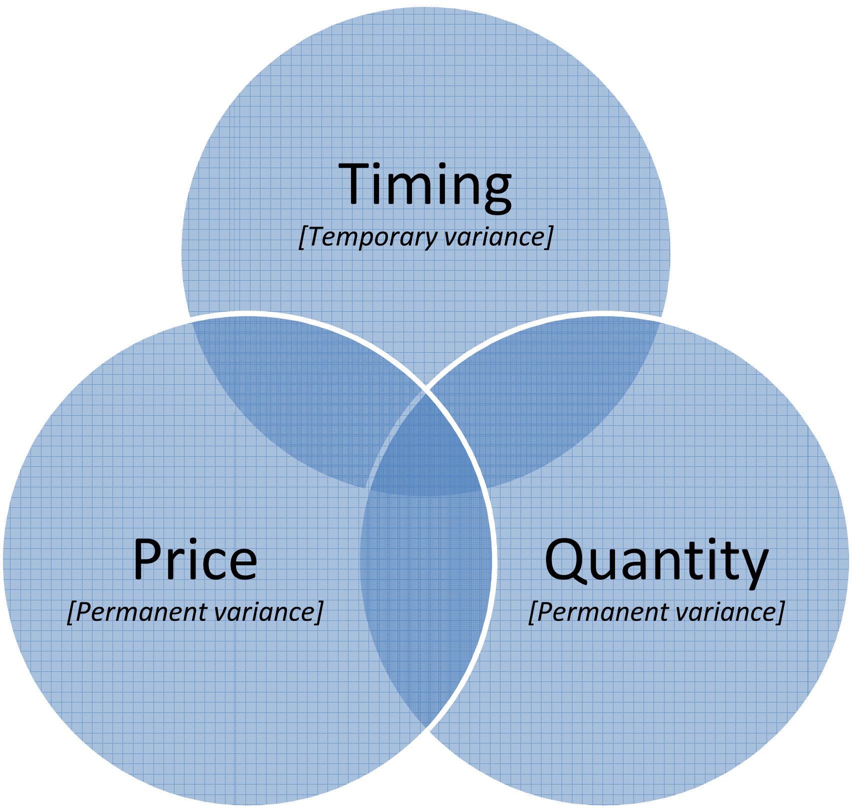
A **favourable variance** happens when:

- actual income is higher than the budgeted amount, or
- actual spending is lower than budgeted (but note that this is not always good news for an NGO).

An **adverse variance** happens when:

- actual income is lower than the budgeted amount, or
- actual spending is higher than budgeted.

Figure 5.2: What causes variances?



The next step is to understand what has caused the variance to happen. In all cases, a variance represents a change from the original plan but what lies behind it? Generally, we can say that variances will be the result of a change in one or more of:

- the **timing** of the activity
- the actual **price** achieved or
- the actual **quantity** of goods or services taken.

Sometimes a variance on a report will be due to an error in the figures rather than a change in plan, for instance a mis-coding in the accounting records.

We classify variances using the three criteria in **Figure 5.2** to highlight where management attention and action is required. This helps to decide if the variance is temporary or permanent – will the variance continue or will it work through the system out over time?

Temporary variances

Variances caused by a change in the planned timing of an activity (eg due to delays or rescheduling) are described as *temporary* variances because they will most likely work themselves out during the course of the year. These are therefore generally less of a concern and no corrective action is required.

Example

The project plans to purchase a vehicle in month 1 but supplies are held up at the port by Customs. The budget monitoring report will therefore show a big positive variance on the Vehicles line (because the budget has not been used yet).

By month 2 the vehicle arrives and is purchased – just a bit later than planned.

The budget monitoring report will no longer show a zero spend on vehicles and the previous large variance will be gone as it was a *temporary* variance due to a timing issue.

Permanent variances

Variances caused by changes in the price or quantity of particular budgeted items generally fall into the *permanent* variances category because once this has happened, there is no going back. The only way to recover the situation is to make an action plan, eg to reduce spending on future items.

These variances are therefore generally more serious and management attention and corrective action is required.

Example

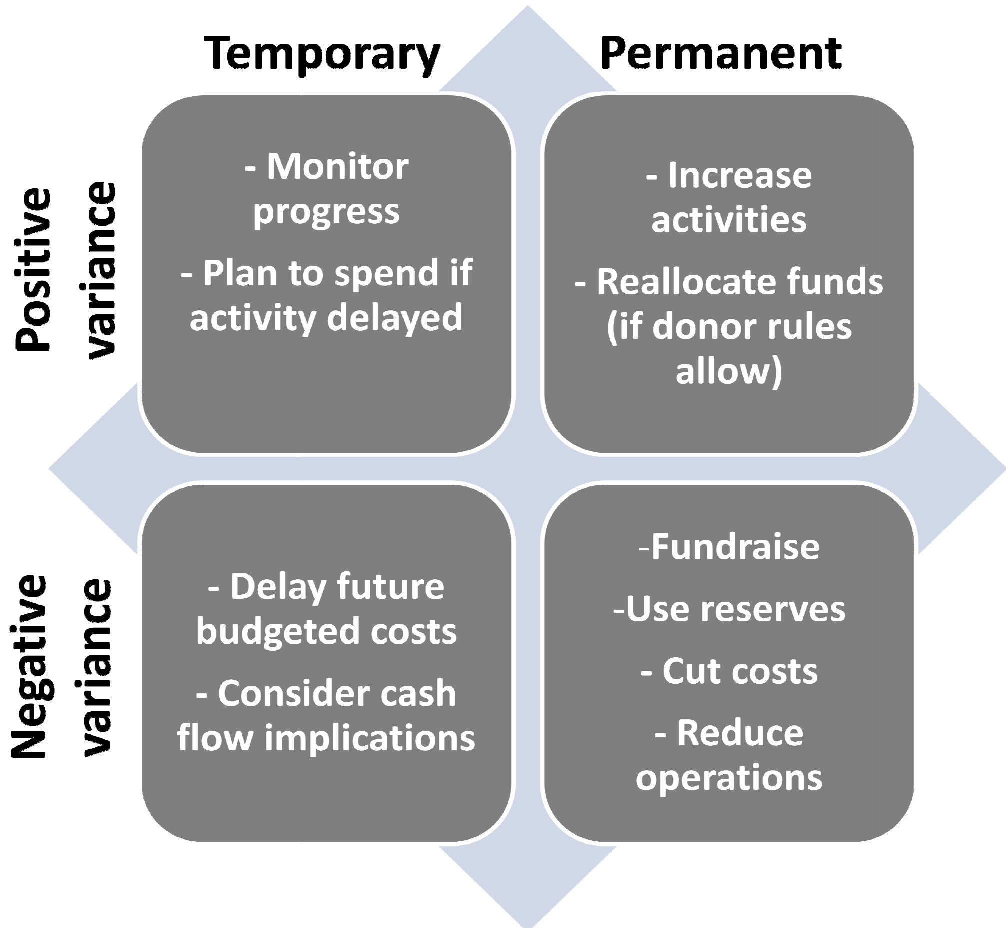
The invoice for the vehicle is paid in month 3. The price of the vehicle has increased by 10% due to a fluctuation in the exchange rate.

The budget monitoring report for month 3 now shows a negative variance on the vehicles line equal to the difference between the budgeted price and the actual, higher price paid. This is a *permanent* variance caused by a change of price. A decision has to be made on how to fund the additional 10% on the cost of the vehicle

Action Planning

Having analysed the figures in management reports, it is then important to work out appropriate corrective action, if needed. **Figure 5.3** summarises the actions open to managers to take on variances, once analysed using the classifications systems described above.

Figure 5.3: Action to take on Variances



Deciding on the action to take, will depend on many factors including:

- knowledge of the project – where it is now and what the activity plans are for the next period
- awareness of external factors – eg inflationary trends, dependence on other programmes meeting their targets
- how serious the variance is
- how controllable, or otherwise, the budget items are
- what the impact would be to take no action
- donor rules and conditions.

It is useful to use a Budget Management Action Planner table to help you manage and control your budget. It can be used to discuss action plans with manager and the project team and to monitor progress of the action plan.

See **Table 5.4** for an example format and **Table 5.5** for an explanation of how to use it.

Table 5.4: Budget Management Action Planner Format

Budget Management – Action Planner					
1	2	3	4	5	6
Line item description	Variance % or £/$	Variance Type	Contro-llable?	Impact on project and grant if not corrected	Action required / by
Smile Trust Grant	($12,500) 100%	Temp.	Yes	The delay is causing project delays too as we cannot buy vehicle	CEO to contact donor and explain this is causing project delays.
Salaries	$2,000	Perm't	Yes	Under spend due to vacant post. This is now filled but project activities delayed which could cause problems with donor.	Contact donor to explain why there are delays and request use of under-spend to hire additional staff for a short period to help catch up

Table 5.5: How to use the Budget Management Action Planner

Column heading	What it means
1 Line item description	The budget line that requires some corrective action.
2 Variance % or monetary value	Include items that exceed +/- 10% variation from the budget and which represent a significant sum.
3 Variance Type	Permanent or temporary? Remember that temporary variances will work their way through the system but very large ones might still have an impact, eg on cashflow.
4 Controllable?	To what extent can you control use of the budget, eg to restrict its use or make savings if over-spent or stimulate its use if under-spent.
5 Impact on project & grant management if not corrected	eg Cash flow, achieving targets, meeting timeframes, allowable costs.
6 Action required/by	What should be done (and by who) to minimise the impact and get the project back on target and/or to meet donor requirements? Eg budget reforecast or adjustments; advise donor of delays or request 'no-cost' extensions; request unrestricted funds to cover over-spends; change activity plans; put efforts into reducing costs or stimulate spending; etc.

Reporting to Donor Agencies

It is worth remembering that donor agencies are themselves accountable to stakeholders (trustees, government, tax-payers, etc.) and they rely on you to provide them with the information they need.

■ Accountability

Financial accountability requires that you demonstrate to the donor that their funds have been used for the purpose for which they were intended. The reference point is the original funding application and guidelines are usually provided with the confirmation of grant aid and the contract or agreement signed by both parties.

It is important to comply with the conditions and meet reporting deadlines to establish credibility and encourage confidence, and to make sure your grant arrives on time.

■ Terms and Conditions of Grant Aid

It is important always to check what you have agreed to do as part of the agreement for funding from each of your donors. Conditions imposed by donors vary enormously but can include:

- **Progress reports** – frequency, format and style of reports, usually quarterly to coincide with release of grant instalments.

- **Scope and designation of funds** – what funds may, or may not, be used for; whether funds can be carried forward from one financial year to the next.
- **Administrative overheads** – the specific items that are allowable or excluded, or a percentage limit based on the total grant.
- **Budget line items** – specific budget headings/account classifications which correspond with the original grant application.
- **Virement policy** – ie permission (or otherwise) to transfer surpluses in the budget from one budget heading to another, and within what limits.
- **Accounting method** – Accruals or Cash accounting.
- **Bank Accounts and interest** – separate bank accounts are required by some donors and/or they do not allow you to keep any interest earned on sums invested.
- **Depreciation policy** – how to treat fixed assets purchased with a grant.
- **External Audit** – some donors require a separate external audit.

The Donor Report

Donors require that an NGO is able to demonstrate financial soundness before granting the release of funds. This is why the donor report is so important. In most cases the report will include a budget compared to actual summary, accompanied by a narrative report on the activities being undertaken. See Appendix 15 for a sample donor report.

Where there are several donors it is important to set up the accounting systems so that the information required by the donor agency can be easily retrieved.

Otherwise the organisation will be involved in a tedious information gathering exercise every time a report is required. The use of Cost Centres is particularly useful here.

When putting together a report to donors do:

- meet reporting deadlines (or request an extension)
- produce accurate and verifiable figures
- not conceal under-spends or over-spends
- explain any significant variations
- keep the donor informed of any potential problems.

Finally, bear in mind that donors have a lot of experience of working with groups like your own; they will almost always respond positively to requests for advice.

Presenting Financial Reports

We spend a lot of effort when preparing reports so it is important that they are used and not just put to one side. So do spend some time thinking about who the reader is and what they will find most useful.

■ 'Exceptions' reporting

Managers and Board members are busy people and they rarely have the opportunity to read all reports that get sent to them. With financial reports it is good idea to provide an *exceptions report* – a brief cover note that draws attention to key areas or need decisions.

The exceptions report is usually no more than one or two pages long and should avoid using technical jargon. It should be brief and easy to read. A suggested layout:

- **Overview** of the period being reported – ie dates covered; how figures have been compiled; what activities are covered by the attached reports; and author of report.
- **Significant variances** - Highlight the most significant variances from the budget and explain the reasons behind the variances. This should not just concentrate on over-spending of budgets – under-spending can also be a problem, especially when related to donor-funded projects.
- **Recommendations** for action – ie corrective action required to deal with the key issues identified in the previous section. For example, strategies to avoid a cashflow crisis in future months; revised activity plans to get projects back on target; restricting use of vehicles where running costs are running too far over budget.

■ Presentation of figures

Negative figures in project financial management reports can be represented in two ways:
– 1,234 or (1,234)

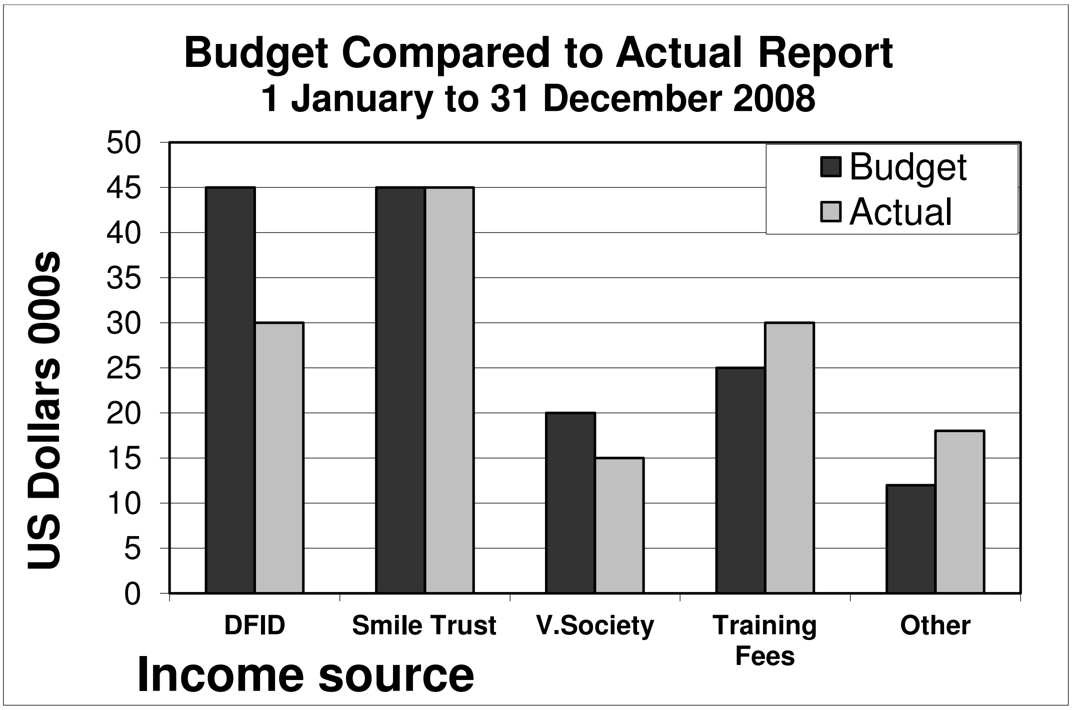
Figures are usually rounded to the nearest whole number – the cents are not relevant to the overall review of the results. This sometimes may result in figures being out by 1.

■ Alternative formats

Graphical formats – for example using a bar chart for a budget-actual report (as in Figure 5.4) or a pie chart for an income and expenditure report – are a welcome alternative to tables of figures, especially for people who are less confident around figures.

See also some very interesting ideas on alternative ways to present financial information from Little Fish in Australia: http://www.littlefish.com.au

Figure 5.4: Using graphics for financial reports



Similarly, rather than present figures, we might simply present a list of statements such as in this example of an alternative Balance Sheet format (see Appendix 9 for the usual presentation):

Milestone Project Financial position on 31 December 20xx:

a) Our programme equipment and vehicles – after a deduction for wear and tear – had a value of UC112,091.

b) We had UC8,095 help as cash and in the bank.

c) The Smile Trust owed us UC10,000 for the final quarter grant; and we had some outstanding fees and other small amounts owed to us totalling UC2,459.

d) We owed a total of UC3,262 in unpaid invoices.

e) This means that if we paid off everything we owe from our available funds, we would have UC17,292 to continue our operations.

f) Our overall reserves, including the value of our equipment and vehicles, total UC129,383.

Reporting to Beneficiaries

Most NGOs recognise the need for downward accountability – ie reporting to the communities they work with. But few have set up systems to deliver it: most NGO systems focus on upward accountability, such as reporting to donors, Boards and Head Offices.

To participate fully in an NGO's work, beneficiaries need access to information about the NGO's plans, resources and activities. Increasing transparency and accountability to beneficiaries has many benefits including:

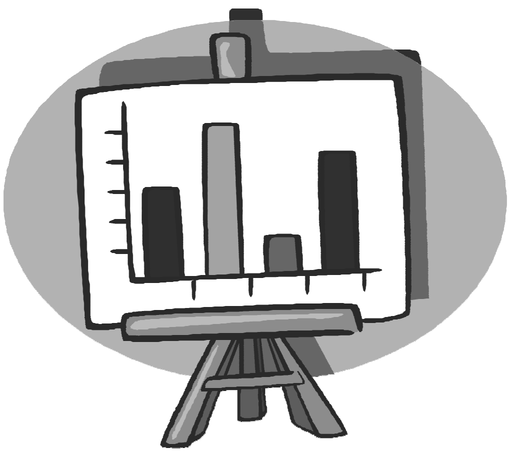
- Strengthening trust and respect between NGO staff and beneficiaries
- Improving the quality of programme decisions, as beneficiaries provide feedback on how funds are being spent
- Empowering beneficiaries to make their own decisions on their own behalf
- Reducing the risks of inefficiencies and fraud
- Encouraging finance staff to get more involved with NGO field work

Introducing this level of financial transparency may naturally hit some obstacles, such as adding to the burden of already busy staff. But if sensitively done, the benefits generally far outweigh the costs.

Some good practice ideas on how to practically report to beneficiaries include:

- Making information easier to understand by using graphical presentations
- Using white-boards outside offices to display budgets, the amounts of funds available for each area and a monthly update of expenditure.

For more ideas on how to report to beneficiaries and information about Mango's "Who Counts?" campaign, please visit: **www.whocounts.org**.



Summary: Twenty Questions

Here are 20 questions to ask when reviewing financial information:

Auditors Report on the Annual Financial Statements

1. How long ago was the last audit conducted?
2. What does the Auditor's Opinion say – is it qualified or unqualified?

Balance Sheet

3. Does the organisation have enough ready cash (see 'Cash at Bank' listed under Current Assets) to pay off its immediate debts (see Creditors)?
4. How long could the organisation survive if all of its funding dried up? (Calculate the 'survival ratio') How does this compare to last year?

Income & Expenditure (or Profit and Loss) Account

5. Is income and expenditure broadly in balance? (Look for net income/expenditure)
6. Is there a significant increase or decrease in activity levels from the previous year?
7. What is the balance of direct project costs vs. admin costs? Is it reasonable for the size and nature of the organisation?
8. How 'donor dependent' is the organisation? (Calculate the 'donor dependency ratio')

Budget Monitoring Report

9. Is expenditure broadly in line with the budget? (+ 10%)
10. Is income broadly in line with the budget?
11. Are there any significant variances? If so, have they been satisfactorily explained?
12. What action is being taken to correct significant variances – eg under-spending as a result of delayed activity plans?
13. Are there any large bills outstanding which could substantially affect the figures shown?
14. Are we owed any large sums of money? What is being done to retrieve them?
15. Are there any un-budgeted expenses which may occur in the rest of the year?
16. What is the projected end-year outcome? Is this outcome satisfactory? If not, what steps can be taken to change the result?

Cashflow forecast

17. Is there enough cash in the bank to fulfil the activity plan in the next six months?
18. What grants are due and are they still expected to come through on time?
19. Are spare cash balances invested to produce the best return?

General

20. What non-financial figures are being produced to show how the programme of activities is progressing?

Chapter 6

Safeguarding Your Assets

'It is more sensible to establish a system to deter fraud rather than one to discover it'.'

This chapter:

- Explains the importance of introducing internal controls
- Outlines the principles of delegation of authority and separation of duties
- Highlights the importance of cash control and reconciliation
- Discusses ways to manage and control fixed assets
- Provides some tips on how to detect fraud
- Gives advice on how to manage incidences of fraud and other irregularities.

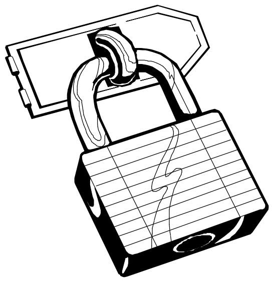
Managing Internal Risk

Here we are concerned with managing internal risks facing an NGO on a day-to-day basis. This is achieved with a series of controls, checks and balances, which, if operated properly, will avoid losses and detect errors and omissions in the accounting records.

Controls are also very important in protecting all those who handle the financial affairs of the organisation as they remove any suspicion of, or temptation to, dishonesty.

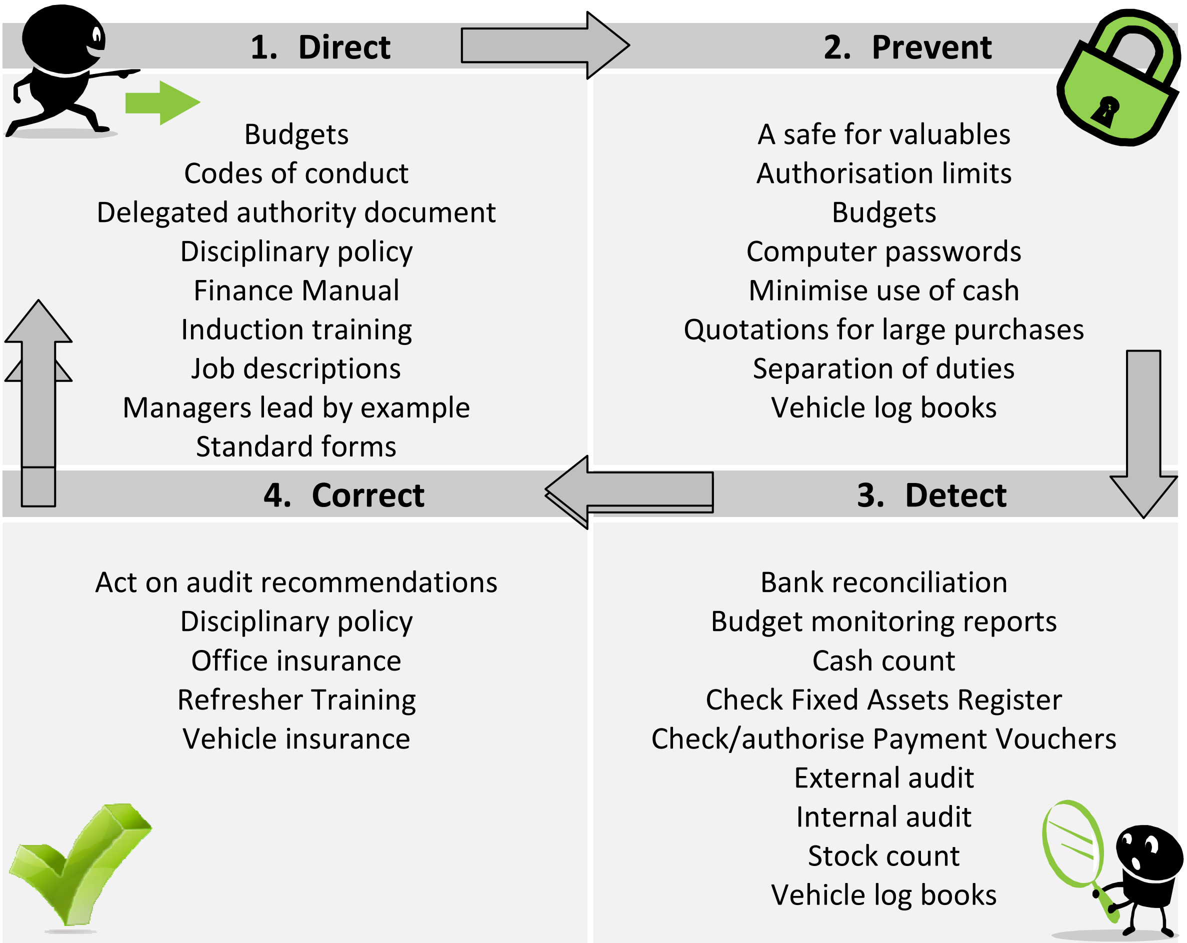
There are several different categories of internal controls:

- Delegated authority
- Separation of duties
- Reconciliation
- Cash control
- Physical control



The Four Actions of Internal Control

A simple way to set up your internal control systems and procedures is to use the Four Actions approach:



1. DIRECT: encouraging the right action

This means setting policy, giving clear instructions on who does what and what processes to follow, such as the Procurement process and delegated authority.

2. PREVENT: deterring the wrong actions

Sometimes, there will situations where someone fails to follow the guidance in the *Direct* stage so we need to set up systems that will, as far as possible, minimise the risk of opportunistic theft or loss due to incompetent actions. This includes commonsense physical controls and checking actions during a process.

3. DETECT: identifying if and where it has gone wrong

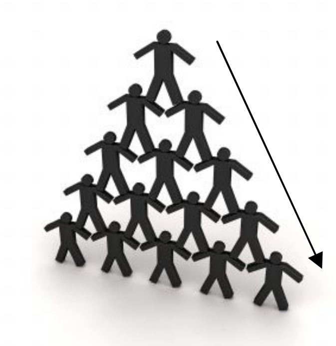
We cannot prevent all incidences of loss, so we then need to have systems in place to pick these up after the process is completed (and learn from it too). For example, cash counts, ban k reconciliations and internal audit.

4. CORRECT: putting right the errors or losses detected

This includes making insurance claims, correcting accounting records and changing policies to reduce the chance of the loss happening again. This process of learning links back to *Direct* as guidance is updated, so completing the cycle.

Delegated Authority

The Board of Trustees delegates authority through the Chief Executive for the day-to-day running of the organisation. In a large and busy organisation it is not practical to expect one person to make all the decisions and authorise all transactions. The Chief Executive will, therefore, further delegate authority to members of the staff team to relieve the load and to ensure smooth operation during absences of key staff.



■ Delegated Authority Document

Every organisation should decide in advance who should do what in finance procedures. It is good practice to record what has been decided in a **Delegated Authority document**. Its purpose is to clarify who has the authority to make decisions, commit expenditure and sign legal undertakings on behalf of the organisation so that there is no confusion about responsibility. [See an example in Appendix 2.]

The Delegated Authority Document should include instructions for such duties as:

- Placing and authorising orders for goods and services
- Signing cheques
- Authorising staff expenses
- Handling incoming cash and cheques
- Access to the safe and petty cash
- Checking and authorising accounting records
- Signing legal undertakings

The Delegated Authority document must be approved by the Board and reviewed every year to ensure it is still appropriate to current needs. It should also outline deputising arrangements to cover for absence of key personnel. A breach of delegated authority is a serious matter and should be dealt with through the organisation's disciplinary procedures.

Authorisation rules

When writing a delegated authority document there are some basic rules to observe:

- **The lowest level of authority is defined** – it is taken for granted that those higher up the management ladder will also have the same authority.
- **No one should authorise any transaction from which they will personally benefit**. This makes the individual vulnerable to accusations of abuse.
- **Staff must not authorise payments to their managers** – they must be passed to someone who is more senior in the management structure, or the Board.

Any limits or conditions that apply to delegated authority must be clearly defined. For example, a person may be authorised to commit expenditure up to a specified amount or within certain categories of expenditure or within budget.

Separation of Duties

In order to protect those operating the procedures and to prevent any temptation to mis-use funds, there must be a separation of the various duties within the finance procedures.

For example, the duties of ordering goods, receiving goods, authorising the payment, keeping the accounting records and reconciling the accounts should not fall entirely on the shoulders of one person. Apart from weakening financial control, this puts too much responsibility on one person and if they should leave the organisation or are absent for long periods, then the finances will grind to a halt.

As far as possible then, duties should be shared between the staff team (and Board members if there are only one or two staff members).

Procurement Procedure

A Procurement Procedure sets out the steps and conditions that have to be followed by staff to acquire goods and services so that the objectives of the organisation can be fulfilled efficiently and effectively. See below for the typical stages in a procurement process.

This is a prime example of separation of duties in action. The procedure will:

- outline the process and authorities for ordering, receiving and paying for goods and services (see below);
- describe which method of payment or acquisition is to be used for different goods and services – for example, when it is acceptable to use petty cash (this should be rare), bank transfers (eg salaries) or suppliers' accounts (eg stationery, petrol);
- clarify when it is necessary to obtain quotations from suppliers – eg 2 quotations for all expenditure over $100;
- include a list of Approved Contractors or Suppliers, if used.

The Procurement Procedure is covered in more detail below.

■ Signing cheques

Each organisation should have a panel of cheque signatories from which to select the required number of authorising signatures; there should be sufficient people nominated to ensure efficient administration of payments. Signatories should be regularly reviewed and the list updated when people leave the organisation.

It is usual to have more than one signature on a cheque to help avoid fraud.

> *NEVER ask signatories to sign blank cheques for future use as this defeats the whole purpose of having more than one signatory.*

■ Checking and authorising accounting records

A key responsibility of managers (the Chief Executive or Financial Controller in a larger organisation or a Treasurer in a smaller one) is to check and authorise records, count the petty cash and review orders for supplies, from time to time.

This provides an essential check on processes and is central to the concepts of separation of duties and risk management.

The Procurement Process

Each organisation must design a procurement procedure which suits its own circumstances. **Figure 6.1** shows some typical stages in the process and demonstrate separation of duties.

1. Specify goods or services to be purchased, check budget

The standard, quantity and price of goods or services required, as described in the activity plans, is clarified so that it is clear what needs to be purchased. The amount currently available in the budget for the item to be purchased should be checked at the specification stage in case the price has changed since the budget was prepared.

2. Prepare Purchase Requisition

An internal request is prepared – usually on a standard form for that purpose – to formally request the purchase of the goods or services specified. The request will include a description of the purchase and state why it is required.

3. Authorise Purchase Requisition

The purchase requisition will usually be checked and authorised by the budget holder or other nominated person to verify that there is a genuine reason for the purchase. The available budget will usually be checked again at this stage.

4. Obtain Quotations

Quotations from reputable independent suppliers are requested (in accordance with internal procedures and donor rules) to make sure the organisation gets best value for money and to minimise the risk of collusion.

5. Select Supplier

Quotations are reviewed and a supplier is selected based on price, quality, delivery times and 'after sales' terms to ensure value for money. For larger purchases, it is usual to have a Purchasing Panel – a small group of managers who take responsibility for selecting the supplier.

6. Issue (Authorised) Purchase Order (PO)

A properly authorised Purchase Order is sent to the selected supplier with a copy kept on file with the supplier's quotation. This is a legally binding contract.

7. Receive Goods from Supplier

When supplies are delivered and received, a Goods Received Note (GRN) is usually signed to confirm receipt and a copy filed for later reference.

8. Receive and Check Supplier Invoice

The invoice should be checked and matched up with the GRN, PO and quotation, usually by the finance team.

9. Prepare and Authorise Payment Authority

The Payment Authority is attached to the invoice and all the supporting documents. It includes budget and accounting codes and must be checked and authorised by the budget holder or other nominated person.

10. Pay Supplier Invoice

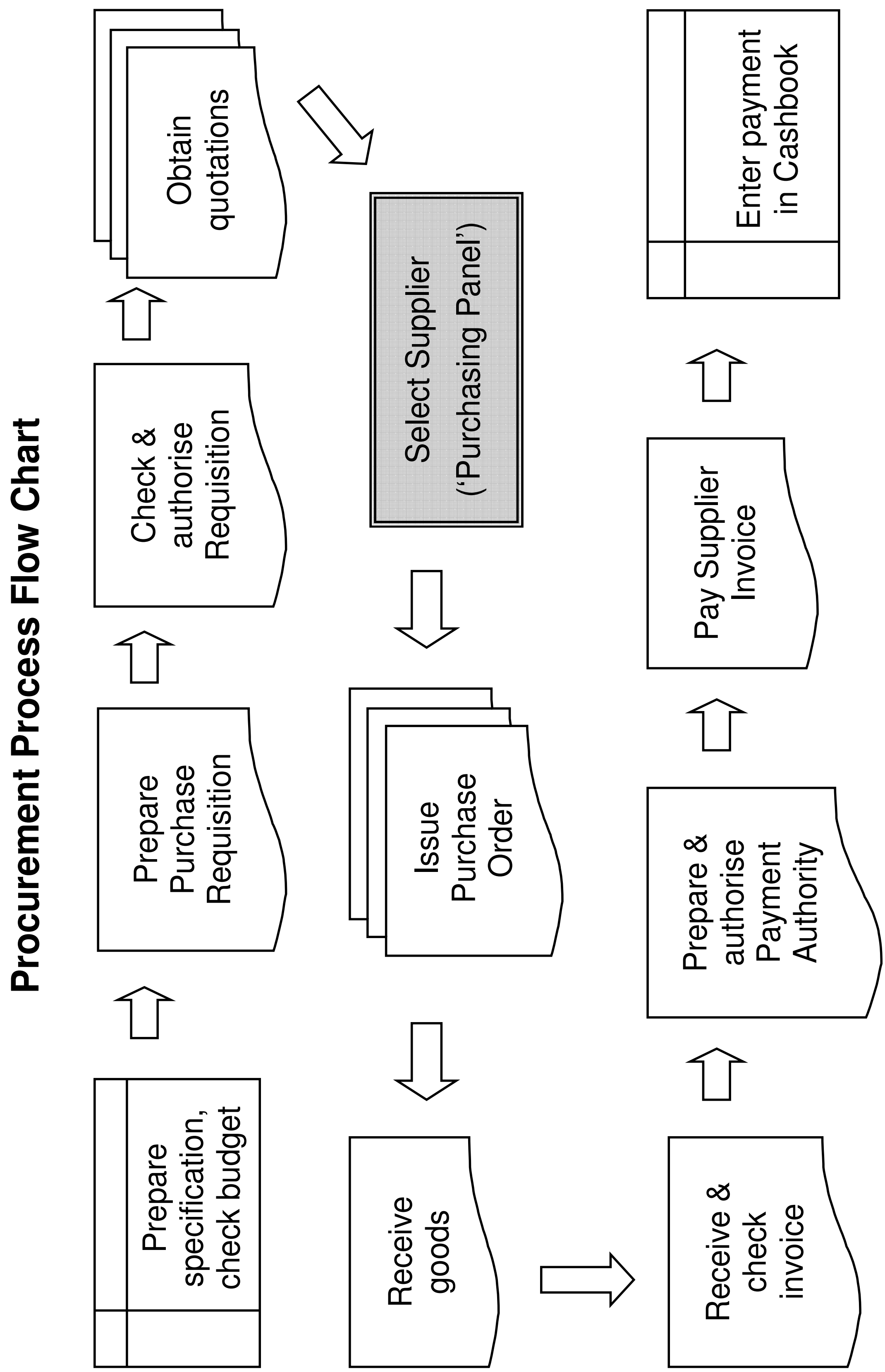
Payment should be made to the supplier within the specified payment terms, usually 30 days.

11. Enter Payment into Cashbook

The final stage is to record the payment in the organisation's books of account.

Note that the procurement stages described here are for major orders not small cash purchases.

Figure 6.1 Typical Procurement Process



The Reconciliation Process

Reconciliation involves verifying accounting records to make sure that there are no errors or omissions that have so far gone undetected. Records that should be reconciled at regular intervals are:

- Bank Book
- Petty Cash Book
- Stock control records
- Salaries and Deductions schedules

Once the records have been successfully reconciled, the reconciliation statement must be passed on to be independently checked with the source records by a line manager or a committee member. The process may also highlight follow up actions, eg corrections to records.

As noted above, this checking duty is a key responsibility of the manager or Treasurer.

■ Bank Book

The Bank Book should be reconciled to the bank statement at least once a month. The purpose of this exercise is to make sure that the organisation's own records agree with the bank's records which are rather like a parallel set of records. This is achieved by taking the closing bank statement balance for a particular date and comparing it to the closing Bank Book balance for the same date, then explaining the differences.

This is an important check not only for accuracy and completeness of records, but also as an early indication of fraud. (Also see page 51.)

■ Petty Cash Book

The petty cash should be counted and reconciled at least weekly. If the imprest system is in use, this is a very easy operation as it is simply a matter of counting up all the payments made since the last reimbursement and counting the cash in the tin. The two totals together make up the total float. If a discrepancy is found, it must be noted in the petty cash book as either an 'expense – unidentified' or a 'surplus – unidentified' and allocated to an appropriate category. Discrepancies must be reported to a manager.

■ Stock records

Stock records must be checked against the supplies held in the store and receipts from sales to ensure that no errors have crept in (and no stock has crept out).

A **Sample Stock Control Sheet** for some T-shirts is reproduced below in **Table 6.1**. It shows the value of the stock the last time it was reconciled. Then it lists new stock purchases and new sales. This gives us an *expected* stock value, on paper at least.

Note that the table lists both the cost value (ie what the organisation paid the T-shirts supplier) and the resale value (ie what the organisation expects to sell the T-shirts for).

However, when the T-shirts in the stock room are physically counted and checked, the actual value is less than expected. (The brackets around the bottom line figures indicate the stock value is short.)

What do you think might explain this difference?

Table 6.1 Sample Stock Control Sheet

	Cost Value $	Resale value $
Value of stock at 1 Jan 200x	3,000.00	6,000.00
Add: Value of purchases between the period 1 Jan. to 31 Mar. 200x	800.00	1,600.00
Deduct: Value of sales during the period	1,300.00	2,600.00
EXPECTED STOCK VALUE:	2,500.00	5,000.00
ACTUAL STOCK VALUE	2,450.00	4,900.00
Difference	**(50.00)**	**(100.00)**

This difference might be caused by one of several things:

- **The value of new purchases could be wrong** – eg the stock delivered was short. This could happen if a delivery is not properly checked against the delivery note and invoice when received from the supplier.
- **The value of sales could be wrong** – eg the wrong amount could have been charged or a sale not recorded or coded properly.
- **Stock could have been stolen**.
- **Stock could have been given out** as gifts or for publicity purposes and not recorded as such in the accounts.

Whatever the explanation, the difference has to be investigated and systems reviewed if necessary. This demonstrates well the importance of regular stock checks.

■ Wages Book

The wages records, and particularly deduction records, are notorious for containing inaccuracies and for abuse in the form of 'ghost employees' (ie people on the payroll who do not exist and where a salary is paid and collected by a fraudster).

Wages records must be reconciled every month to ensure that the correct deductions are being made and passed on to the relevant authority. Failure to do so could result in severe penalties and interest being imposed – and cause discontent amongst the staff.

Cash Control

It is important to observe the **Seven Golden Rules for Handling Cash** as follows:

1. Keep money coming in separate from money going out

Never put cash received into the petty cash tin, it will lead to error and confusion in the accounting records. All money coming into the organisation must be paid into the bank promptly and entered into the records before it is paid out again. Failure to do so will distort financial information.

For example, a training course is run by an organisation and a charge of $25.00 is made to each of the 10 participants. The cost of food and room hire is $150.00 and this is paid from the course fees received on the day. The balance of fees – $100.00 – is paid into the bank as Training Fees.

Why is this a problem? The cost of providing food and room hire has not been entered into the accounts and cannot therefore be reflected in a financial report. Similarly, as only the net amount of fees received has been paid into the bank, it would appear that only a few people actually attended the course and the income generating potential of running such a course has been disguised.

2. Always give receipts for money received

This affords protection to the person receiving the money and assures the person handing it over that it is being properly accounted for. Receipts must be written in ink, not pencil, and preferably from a numbered receipt book.

3. Always obtain receipts for money paid out

Sometimes this may not be possible. For example, when purchasing materials from a market; in this case the cost of each transaction should be noted down straight away so that the amounts are not forgotten and these can then be transferred to a petty cash slip and authorised by a line manager.

> ***Remember*** *– no receipt means there is no proof that the purchase was made.*

4. Pay surplus cash into the bank

Having cash lying around in the office is a temptation to a thief and the money would be better managed if it were earning interest in a bank account. A casual approach to cash on the premises might also lead to people wanting to 'borrow' from it – many a sorry tale of fraud has started in this way.

You should always aim to pay cash into the bank on a daily basis or, at the very least, within three days of receipt.

5. Have properly laid down procedures for receiving cash

To protect those handling money, there should always be two people present when opening cash collection boxes, etc. Both should count the cash and sign the receipt.

6. Restrict access to petty cash and the safe

Keys to the petty cash box and the safe should be given only to authorised individuals. This should be recorded in the organisation's Delegated Authority document.

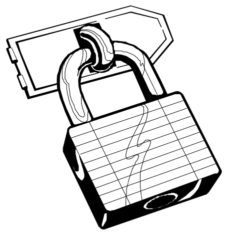
7. Keep cash transactions to an absolute minimum

Petty cash should only be used to make payments when all other methods are inappropriate. Wherever possible, suppliers' accounts should be set up and invoices paid by cheque. The advantage of paying for most transactions by cheque is that this has the effect of producing a parallel set of accounts in the form of the bank statement. Also, it ensures that only authorised people make payments and it reduces the likelihood of theft or fraud.

Physical Controls

Physical controls are additional common sense precautions taken to safeguard the assets of an organisation.

■ Having a safe



Having a safe – or a safe place – to keep cash, cheques books, legal documents, etc. is an important consideration. A proper safe is worth considering especially if your organisation has to keep large sums of money on the premises overnight. Safes are however, expensive and if resources are tight then it may be better to improve on banking procedures.

■ Insurance cover

It is the responsibility of the Chief Executive to ensure that there is adequate insurance cover so that if 'assets' are lost, damaged or stolen they can be replaced or compensated. There are many different types of insurance to consider, including

- Office contents against fire and theft
- Buildings against fire, floor and storm damage
- Vehicles against accident and theft.

The decision whether or not to insure property is a good example of managing risk – weighing up the pros and cons of paying for insurance is a common dilemma for managers.

■ Safeguarding Fixed Assets

Fixed assets may represent considerable wealth held in the form of land, buildings, vehicles, machinery and office equipment and, often over-looked, require special attention to ensure their value is maintained and that they do not disappear through lack of vigilance.

The measures to safeguard these assets will include Assets Registers, a vehicle policy and maintenance policies for equipment.

The Assets Register

An *Assets Register* should be established with an entry or record sheet for each item. Each asset should be tagged with a unique reference number for identification purposes. The register will record important information about each asset, such as:

- where and when the item was purchased and how much it cost
- where it is held or located
- how much it is insured for
- repair history
- serial numbers
- details of guarantees or warranties.
- depreciation rate and method, where relevant.

The record sheet should also state who is responsible for its maintenance and security. The Assets Register should be checked by a senior manager or committee member every quarter and any discrepancies reported and appropriate action taken. See Appendix 19 for a sample Assets Register record sheet.

Building and Equipment Maintenance policy

To preserve the value of buildings and equipment, an organisation must have a pro-active policy of maintenance. For buildings this may require a professional planned maintenance contract for which a realistic budget must be provided.

Office equipment such as photocopiers and electrical equipment should also receive regular services by qualified technicians to ensure they are safe and operating properly.

Vehicle policy

Every organisation that owns vehicles should have a vehicle policy. This will set down the policy on a range of issues such as:

- Depreciation
- Insurance
- Purchasing, replacement and disposal
- Maintenance and repair
- Private use of vehicles by staff
- What to do when accidents happen
- Driver qualifications and training
- Carrying of passengers

The costs of repair and replacement must be also adequately reflected in the budget process.

For each vehicle there should be a log of journeys so that the running costs per KM can be assessed and private use closely monitored. (See Appendix 22 for a sample.) Once you have 12 months information on the costs of running a vehicle, it is possible to calculate its average running costs per kilometre.

See below for a worked example.

Table 6.2: Calculating Vehicle Running Costs

Vehicle make/model:	Toyota Hiace Van	
Date purchased:	26 December 2007	
Purchase price:	$20,000	
Depreciation period /method:	5 years, straight line method	
Maintenance:	Service every 6,000 km or every 3 months	
KM run	*From 1 January to 31 December 2008:* Km on clock on 31/12/08 LESS Km on clock on 01/01/08 Total KM run during year:	 20,601 (201) 20,400
1. Depreciation		$
Purchase Price	= $20,000	
Depreciation period	= 5 years	
Annual depreciation charge	= $20,000 / 5	4,000
2. Fuel consumption		
Total fuel bills for the year		5,500
3. Maintenance costs		
Total of invoices for the year for: repairs, service costs, spare parts, tyres, etc		900
4. Insurance and tax		
Insurance, road tax for the year		3,300
TOTAL VEHICLE RUNNING COSTS:		**13,700**
<u>Cost per Km calculation:</u> Total costs for the year Total no. of Km run	 = $13,700 20,400 km	 $0.67

In conclusion: using the information from our accounts and the vehicle log sheet, we can see that each kilometre run with the Toyota Hiace Van cost approx. 0.67 cents.

Dealing with Fraud and Irregularities

There will be occasions when internal control systems fail to prevent losses through theft, fraud or other irregularities.

> ***Fraud is**… Intentionally lying or cheating to gain an advantage or to cause someone else to make a loss*

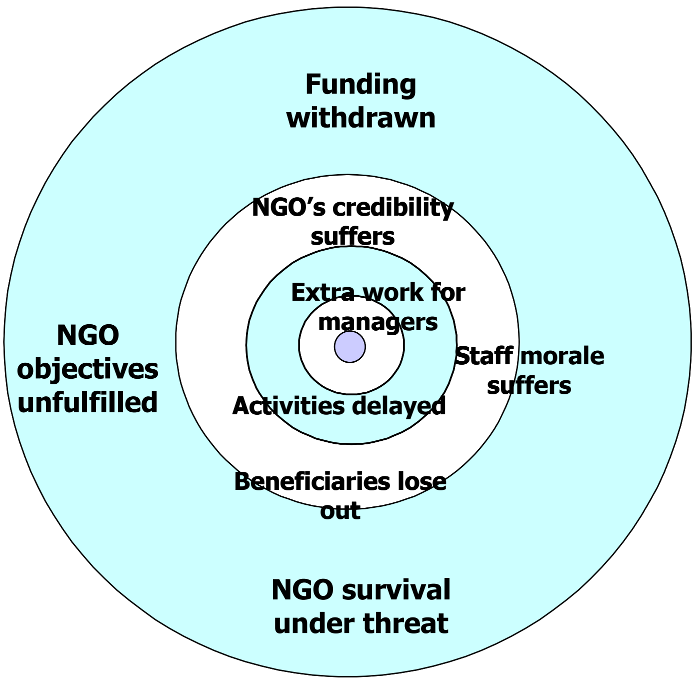
Fraud includes theft of goods or property, falsifying expenses claims, and falsification (or destruction) of records to conceal an improper action. Fraud does not include:

- accounting errors
- actions condoned by established practice
- cases where no loss is incurred.

'Irregularities' include unauthorised activities for private gain: eg 'borrowing' from petty cash; use of vehicles; or abuse of telephones and other equipment.

Inevitably, the impact of fraud has a damaging effect on the organisation. Imagine a stone falling into a pond: the initial splash is the loss of funds or equipment but it does not stop there, as **Figure 6.1** below illustrates.

Figure 6.2: The Ripple Effect of Fraud



Incidents of fraud and irregularities require sensitive handling to minimise the long-term impact. It is important to be prepared to deal with any occurrences of fraud or financial irregularity by having a written procedure which covers steps that need to be taken.

- **Deterrence**

The procedure should state clearly that routine controls, checks and balances are in place to safeguard the assets of the organisation and to protect staff from any suspicion of, or temptation to, fraud or other impropriety. Paid staff and volunteers are therefore obliged to co-operate fully with internal control procedures and failure to do so will be dealt with as appropriate within the organisation's disciplinary code.

- **Types of irregularity**

The procedure will identify different types of irregularity; how seriously they are viewed; and how they will be dealt with. For example, all instances of theft and fraud will be viewed as Gross Misconduct and will result in immediate dismissal and loss of terminal benefits. A clear statement of the organisation's policy on the circumstances in which the Police will be informed must also be made. This must take in account local circumstances.

- **Detection**

A procedure for reporting suspicions of irregularities should be made clear to all. This should make it easy for people to report concerns in confidence and without fear of retribution.

When an irregularity is reported or detected, record the details in writing; report it immediately to a superior. Follow up all reports or suspicions immediately; do not allow rumours to spread or let the 'trail' go cold. (See below for tips on how to detect fraud).

- **Investigation**

When an irregularity comes to light, it must be dealt with quickly and sensitively; look for corroboratory evidence before instigating a formal investigation. If all the evidence points to an irregularity, the individual(s) involved should be formally interviewed with a third person present to take notes.

Protect documents and records by either removing access to them by those involved in the irregularity or by suspending the people involved during the investigation. The policy will identify who is responsible for conducting a formal investigation. This will depend on the nature of the irregularity; it could be conducted by the senior manager, the internal auditor, the external auditor or, in more serious cases, the Police.

- **The Aftermath**

Don't under-estimate the long-term and less tangible impacts of fraud. It will involve a lot of a managers' time during the investigation and afterwards. In particular:

  - People will be distressed by the experience and need to be supported. Colleagues will suffer all the mixed emotions of bereavement: anger, guilt, disappointment and loss. They will be worried that their own jobs are under threat.
  - New staff may need to be recruited and trained.
  - Donors will need reassuring that their resources are safe and the project will not suffer.

Top Tips on the Warning Signs of Fraud

> ***Remember**: "Prevention is better than cure!"*

The following ideas <u>may</u> be an early indication of fraud or abuse. Use with care!

- **From the accounting records:**
  - Lots of corrections to the manual cashbook – this may include extensive use of white-out or blocked out figures
  - Pristine records – ie a manual cashbook that look as if they have all been written on the same day in the same hand. Could be an indication of rewritten/duplicate books
  - Delayed banking of cash received – shown up by bank reconciliation. Could be 'teeming and lading'?
  - Records not being kept up to date – ie deliberately delayed so managers cannot detect false accounting going on.
  - Missing supporting documents – eg certain bank statements destroyed to cover someone's tracks, or a project officer who regularly claims to have 'lost' receipts.
  - Debtors rising unexpectedly – eg if debtors have paid but the cash is being pocketed. This may occur if there are poor controls in issuing receipt books as someone could take an unused book and issue valid receipts without them ever being entered into the accounting records.
  - Hand written supporting documents with errors and corrections on them. Indicates possible changes made after the goods or services were purchased.
  - Cash counts not reconciling to the accounts but reconciling at the next cash count – possible borrowing of funds by the safe key holder.

- **Reports:**
  - Budget monitoring reports showing inconsistent behaviour between line items - eg project-related expenditure is under-spent due to delays – except for fuel which his over-spent. This could indicate abuse of the vehicle.
  - Vehicle log books not maintained in an appropriate level of detail. This could indicate abuse of the vehicle.
  - Budget monitoring reports delayed – to cover up something?

- **Non-financial areas:**
  - Working very long hours – first in last out of the office? Could mean that they are having to do extra work to cover their tracks?
  - Never taking holidays – can't afford for someone else to see what they are doing!

- Change of lifestyle – spending patterns don't match their income (eg designer clothes, social habits, expensive car…)
- Creating 'smoke screens' – where someone is making a false accusation about another team member to give them time to cover their tracks or make a getaway!

And some Ideas on fraud prevention:

- Make sure you have robust internal control systems in place.
- Visit projects, and see if the activities carried out roughly match the expenditure.
- Share financial reports with beneficiaries, and ask if they think they have had value for money (find out how: **www.whocounts.org**).
- Hold regular meetings with other staff at all levels (eg project and administrative staff, board members, etc) to discuss financial reports, making budgets and reports openly available.
- Help non-finance staff and managers improve their financial skills, for instance by reading Mango's Guide to Financial Management (available on the CD-Rom in your training pack.)

Summary

Here are some tips on how to deal with fraud and other irregularities – to keep **RISKS LOW**:

DO	**R**eport the incident to a superior or Board member
	Investigate incidences, gather the facts
	Secure the assets and records
	Keep calm!
	Swiftly act
DON'T	**L**ook the other way
	Overlook the 'fall out' of a fraud
	Withhold information to protect others

> *Above all, remember that prevention is better than cure!*

Chapter

7

Managing Audit

An Independent Check on Accounting Records and Systems

This chapter:

- Explains what an audit is
- Describes the different types of audit
- Provides an overview of the audit report
- Gives advice on how to prepare for and manage the external audit.

What is an Audit?

An audit is an **independent** examination of records, procedures and activities of an organisation, resulting in a report on the findings.

There are two kinds of audit:

- ✓ The Internal Audit
- ✓ The External Audit.

As the name implies, an external audit is primarily for the benefit of those outside the organisation, eg stakeholders and funders. Internal audit is undertaken for the benefit of those inside the organisation, ie trustees and management.

The audit should be a positive experience and not one to be feared; it is an opportunity to receive feedback on strengths and weaknesses in systems. Use your auditor to discuss ways of improving your accounting systems and procedures.

■ Why do NGOs need audit?

Audits are important for NGOs as they demonstrate a commitment to transparency and accountability and bring credibility to the NGO. It is also a legal requirement in most countries to have the financial statements reviewed by an independent auditor once a year.

Internal Audit

Internal audit involves a structured review of systems and procedures, as set by the Board and managers, to ensure efficient and effective practices. It is not an internal 'policing' function, rather an opportunity to improve systems and build internal capacity.

The internal auditor's report will highlight findings and make recommendations for action, where needed. It may be carried out by someone within the organisation, or an outsider may be engaged to carry out an 'internal audit'.

An internal audit will include a range of checks as part of the independent review, including:

- financial accounting systems and procedures;
- management accounting systems and procedures;
- internal control mechanisms.

The internal auditor reviews the adequacy of the design of the systems of procedures, and checks that they are being appropriately implemented. A report is presented to the governing body and management, who respond by taking corrective action, perhaps changing a procedure, or training a staff member.

The 'Three E's' influence an internal auditor's approach:

- **Economy:** paying no more than necessary for the resources needed.
- **Efficiency:** getting the greatest benefit with the fewest resources.
- **Effectiveness:** how successful we are at meeting objectives or 'doing the right thing'.

External Audit

An external audit is an independent examination of the financial statements prepared by the organisation. It is usually conducted for statutory purposes (because the law requires it). External auditors may also be engaged to do other specific assignments, (eg a fraud investigation).

- **Purpose**

The purpose of external audit is to verify that the annual accounts provide a true and fair picture of the organisation's finances; and that the use of funds is in accordance with the aims and objects as outlined in the constitution. The purpose of an external audit is NOT:

- To act as a fraud investigation
- To prepare the accounts
- To provide a certificate to say "there are no problems"
- Proof that internal control systems are effective
- Evidence that accounts are 100% error free.

Although it is not the prime role of the audit to detect fraud, this may of course come to light during the checks that take place. Auditors have thus been described as 'watchdogs not bloodhounds'.

■ Appointment

An external audit can be conducted either as part of the annual review of accounts or as a special review by a donor agency. It is conducted by a firm of accountants with recognised professional qualifications.

Auditors are appointed by the Board of Trustees (or Annual General Meeting) or by a donor for a special audit. They are independent of the organisation employing them. Being independent means that the auditor must not have been involved in keeping the accounting records and is not personally connected in any way with the organisation being audited.

■ What is involved?

Auditors only have a limited time in which to complete their work, so they concentrate on testing the validity of a sample of transactions and results rather than vigorously checking everything. Although an auditor's independence must be respected and observed at all times, they are nonetheless providing a service for a fee – you have a right to expect value for money.

Auditor-speak de-mystified:

Material*: An item is said to be 'material' if it is considered to be significant to the users of the financial statements.*

Test basis: *A representative sample, the rest of the transactions are assumed to be similar to the sample tested*

■ The audit report

An audit results in a report addressed to members which gives an 'audit opinion' as to the 'true and fair' view given by the financial statements (of the state of affairs of the organisation and operations for the period.)

Auditor-speak de-mystified:

'True' *means that the transaction did take place and that an asset exists.*

'Fair' *means that a transaction is fairly valued and that assets and liabilities are fairly stated.*

If the auditors do not agree with the financial results as presented by the organisation, they may issue a report saying that, in their opinion, the accounts are not fine. This could be disastrous for an NGO seeking donor support.

The table below summarises the types of opinion.

Table 7.1: The status of the External Auditor's Opinion

Auditor Opinion	Comment
Unqualified	The accounts do give a true and fair view – 'clean' audit report.
Qualified: Subject to	The accounts are basically OK, apart from specific identified issues, eg an incorrect accounting policy, or specific unsupported expenditure.
Qualified: Disagreement	There are so many errors that the accounts do not give a true and fair view.
Qualified – disclaimer	The auditors are unable to give an opinion, because the records are so poor or incomplete. This is very bad indeed.

If the auditors propose any adjustments or changes to the draft financial statements, these must also be approved by the Board. The audit report is addressed to the members and it is usual to formally accept the report at the Annual General Meeting.

Auditors will also often provide a **Management Letter**. This is separate to the audit report and is addressed to management. The report highlights weaknesses identified in the internal control systems and makes recommendations for improvements. Managers have an opportunity to respond to the findings outlined in the management letter and explain what action they will take.

■ Donor (or Project) Audit

On occasion, donor agencies may request an independent external audit of records and activities and will appoint a qualified person to undertake a review. The primary purpose of such a review is to check that grants are being used as intended and in accordance with the budget in the original funding agreement.

The auditor or evaluator will almost certainly wish to interview staff and committee members and may even request to observe the organisation in pursuance of its activities. Every co-operation should be given during such visits and an effort made to be open and honest about organisational strengths and weaknesses.

What Does the Auditor Need?

An auditor will need a quiet place to work where the checks can take place without interruption. If individual staff members are to be interviewed, then a private room where confidential discussions can take place will also be required. Depending on the type of audit taking place, the auditor will usually give advance notification of the records needed.

Ensure that all the records are up-to-date and properly filed as this will facilitate the routine checks and cause minimal disruption for the organisation. This will also help to save on audit fees. A checklist of records and other documentation which might be requested by the auditor follows over page.

■ An Auditor's Checklist

Group of Records	Description of item
A. Primary records of account:	❑ Cash Books completely up to date to the year-end ❑ File of invoices/vouchers for all items of expenditure ❑ File or book of receipts for moneys received ❑ Bank statements, paying in slips and cheque books ❑ Wages book and records ❑ General Ledger, if kept
B. Summaries and reconciliation statements:	❑ A Trial Balance and/or a summary of all receipts and payments by budget category ❑ Bank reconciliation statements for all bank accounts at the year-end cut-off date ❑ Petty cash reconciliation statement to the year-end cut-off date ❑ Stock sheets
C. Schedules:	❑ Schedule of Creditors (money owed by the organisation) ❑ Schedule of Debtors (money owing to the organisation) ❑ Schedule of Grants Due ❑ Schedule of Grants Received in Advance ❑ Fixed Assets Register
D. Other information:	❑ A letter from bankers to confirm balances [this will be requested by the auditors themselves] ❑ Constitution of the organisation ❑ List of Committee members and staff ❑ Minutes of Board and management meetings ❑ Donor agencies funding agreements and audit requirements

Summary: Different Types of Audit

Area:	*Internal*	*External*	*Donor/Project*
Main purpose	Check effectiveness of systems & procedures	Verify the published accounts give a 'true & fair' view	Check that funds used in accordance with the funding agreement.
Focus of review (starting point)	Systems and Procedures manual	Financial statements & underlying records	Grant agreement
Appointed by	Management (but have direct line to the board)	Board (or members)	Donor, but may use normal external auditor if on approved list
Scope	As per planned schedule based on risk assessment. May be for a specific department, grant or period.	All financial transactions in the accounts, whole organisation	Usually limited to the project and related grant funding.
Report includes	Findings and recommendations for improvements	Auditor's opinion and Management letter	Usually, auditor's opinion(s) and recommendations
Employed by	The NGO or external body (outsourced)	External body	External body (sometimes donor themselves)
Qualifications	No formal requirement	Must be qualified & registered accountant	Usually qualified & registered accountant

Acknowledgement: Grateful thanks to Samantha Musoke, ACA, for her input to this chapter.

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