

# Chapter One

## 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 characterized by poor financial planning and monitoring systems.

But NGOs operate in a rapidly changing and competitive world. If their organizations 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 fulfill 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!

## Financial Management Defined

Financial management entails planning, organizing, controlling and monitoring the financial resources of an organization to achieve objectives.

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

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 organization, and not leaving things to chance. This will involve:

### 1. 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 organization's mission and objectives.

### 2. Managing risk

All organizations face internal and external risks which can threaten operations and even survival (e.g. funds being withdrawn, an office fire or a fraud).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

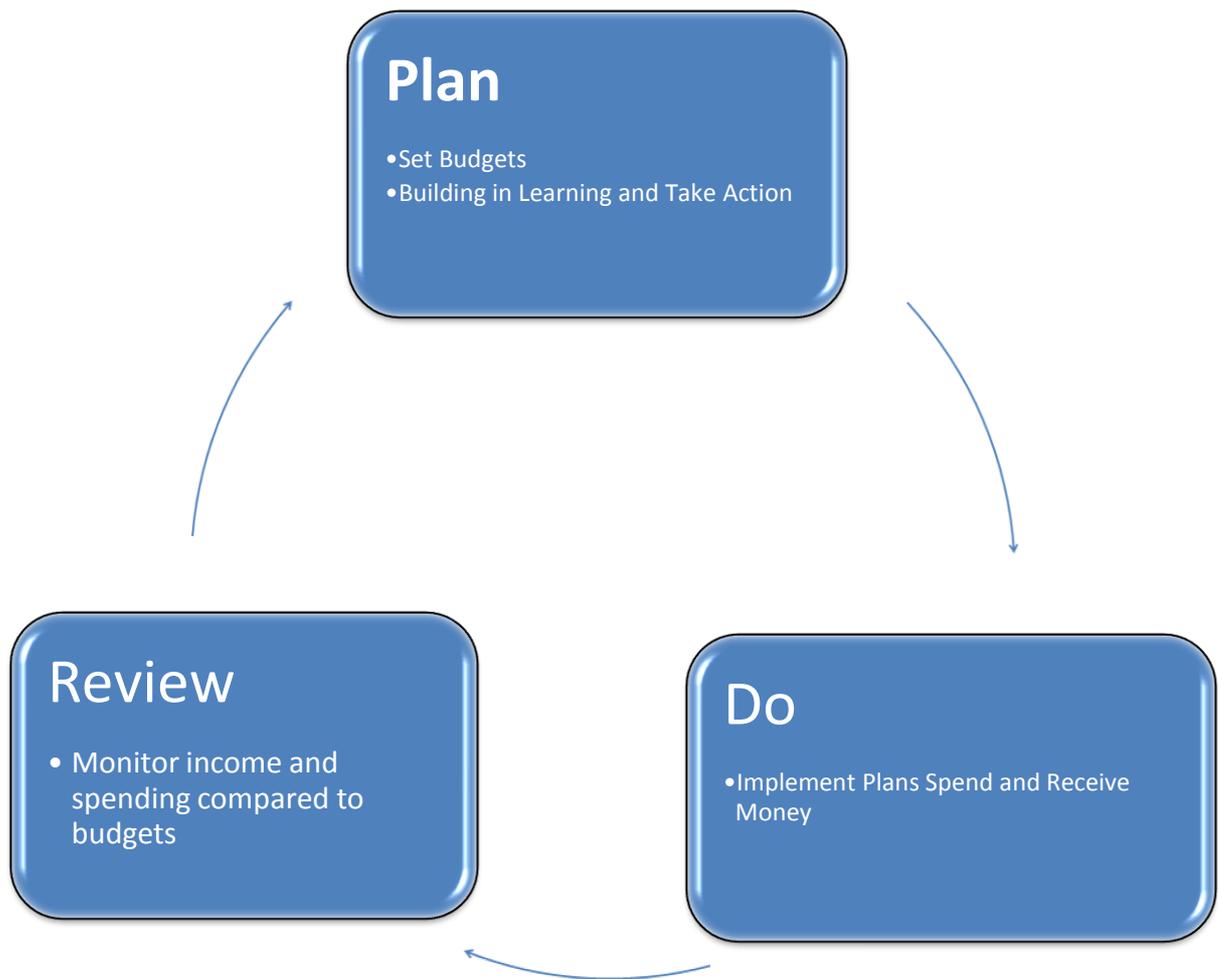
### 3. Managing strategically

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 organization is financed in the medium and long term, not just focusing on projects and programs.

### 4. Managing by objectives

Financial management involves close attention to project and organization 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.



**Plan:**

When an organization 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 program 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 organization 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.

## Financial Control

At the heart of financial management is the concept of financial control. This describes a situation where the financial resources of an organization 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 organization are being properly handled.

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

With poor financial control in an organization:

- 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 organization' 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 organizations, independent of the State.

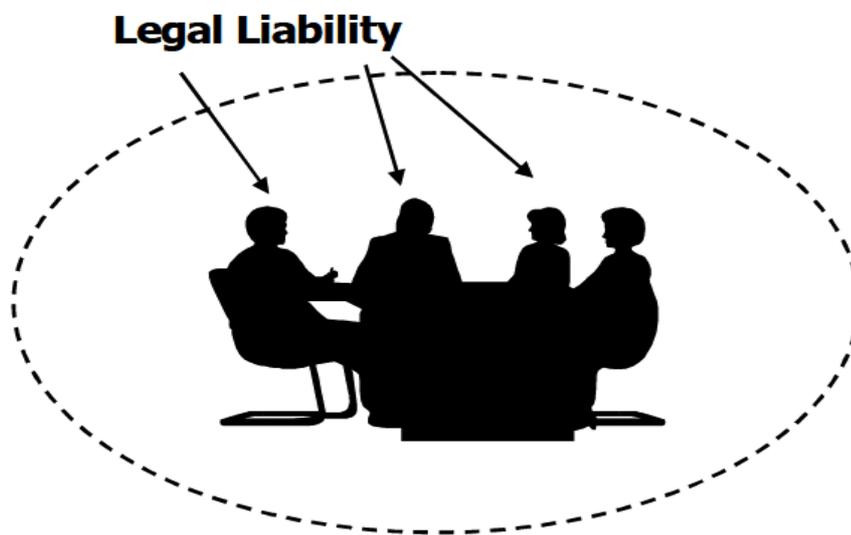
## Legal Status

There are a number of different ways of registering as an NGO and this will determine the organization's legal status. Organizations are recognized 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' (i.e. as a group and as individuals) responsible for the affairs of the organization.

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

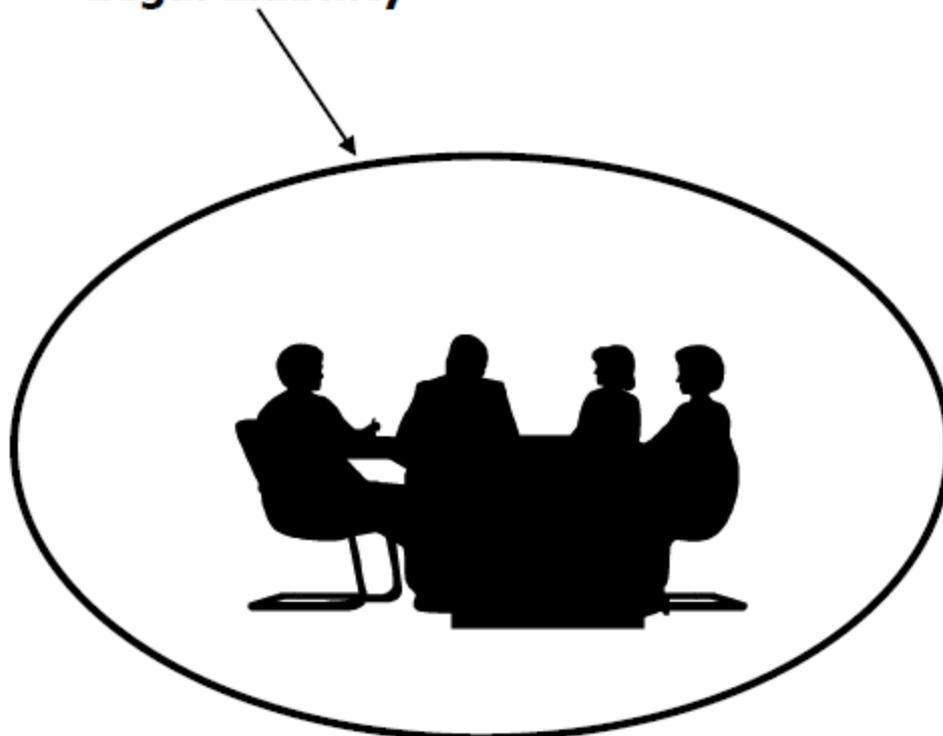
Figure 1.2: Unincorporated NGO



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

Figure 1.3: Incorporated NGO

## Legal Liability



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 (e.g. USD1.00).

Whatever the legal status, the trustees of an NGO together have a statutory duty to see that the organization 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 organization and target group;
- ✓ the system of accountability – i.e. 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 organization. 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 organization;
- ✓ appointing and supporting the Chief Executive; and
- ✓ representing interests of stakeholders.

The governing body is often organized with a series of sub-committees – e.g. Finance, Personnel or Project sub-committees.

## **Board Members**

Board members are volunteers (i.e. 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.

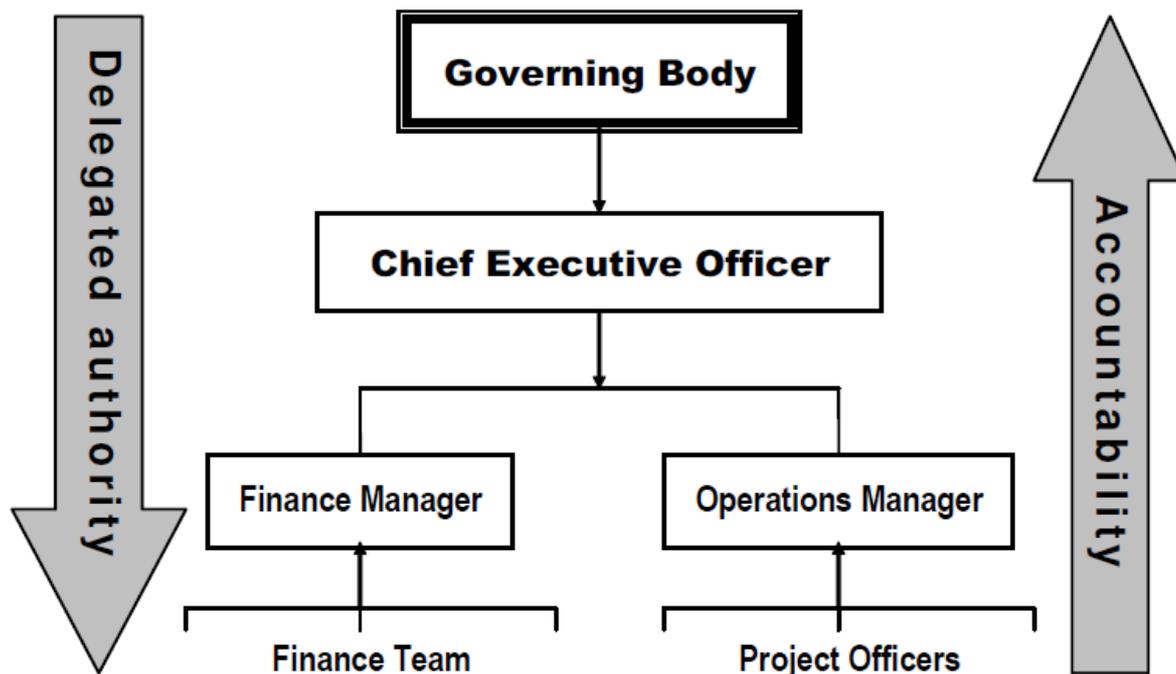
Honorary Officers are those who are elected or appointed to specific positions on the board

- ✓ 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 organization. In a smaller organization 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 organization and they cannot escape this duty except by resigning from the governing body.*

Figure 1.4: Sample Organisation Chart – How authority is delegated



### **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.

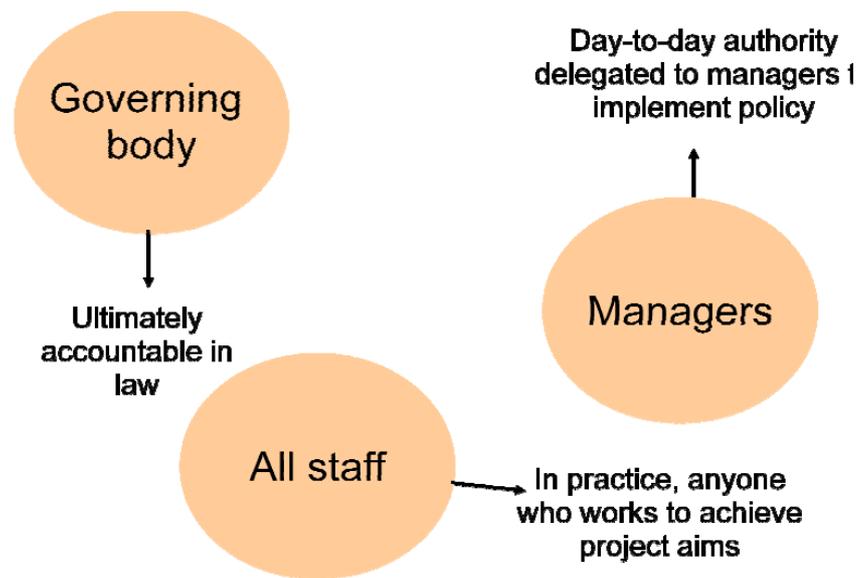
Figure 1.4 demonstrates how the authority for day day-to-day financial management tasks is delegated down through the line management structure. At the same time, the accountability process comes back up through the structure as people report back on progress.

### **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 organization.

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?



## 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 organization 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.

### 1. 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 organization. Inconsistent approaches to financial management could be a sign that the financial situation is being manipulated.

### 2. Accountability

The organization 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 organization to explain how funds, equipment or authority given by a third party has been used.

### **3. Transparency**

The organization 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 organization is not transparent, then it may give the impression of having something to hide.

### **4. Viability**

To be financially viable, an organization'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.

### **5. 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.

### **6. Stewardship**

An organization 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 (e.g. 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.

### **7. 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 organization's system for keeping financial records.

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

## **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.

### 1. Accounting Records

Every organization 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 organization is being managed and whether it is achieving its objectives.

### 2. Financial Planning

Linked to the organization'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.

### 3. Financial Monitoring

Providing the organization has set a budget and has kept and reconciled its accounting records in a clear and timely manner, it is then a very simple matter to produce financial reports which allow the managers to assess the progress of the organization.

### 4. Internal Controls

A system of controls, checks and balances— collectively referred to as internal controls— are put in place to safeguard an organization'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

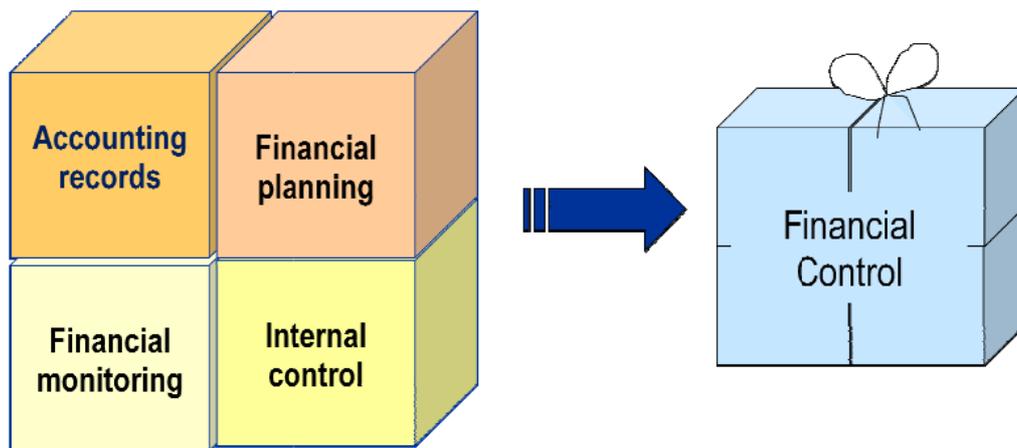


Figure 1.6 illustrates that all of the building blocks must be in place continuously. Effective financial control will not be achieved by a partial implementation.

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.

# 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)

## 1. 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, cash flow forecast, feasibility study...etc.

## 2. Organizing

The resources of the organization-staff and Volunteers, vehicles, property, money- have to be coordinated 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, organization charts, flow diagrams, job descriptions, chart of accounts, Finance Manual, budgets...etc.

## 3. Controlling

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

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

## 4. 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, cash flow reports, financial statements, project reports, donor reports, audit reports, evaluation reports...etc..

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

# Chapter Two

## Getting Organized

*Getting the basics right for your NGO*

This chapter:

- ✓ Explains why it is important to design financial system which are right for your NGO
- ✓ Describes the two branches of accounting
- ✓ Introduces the Chart of Accounts and Project Cost Centers and their important
- ✓ 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 organizing aspects of financial management. NGOs are quite different from commercial organizations 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 organized include:

- ✓ Organization chart and job descriptions of staffs
- ✓ Financial accounts structure – including a Chart of Accounts and Project Cost Centers
- ✓ A ‘Finance Manual’ procedures-or a file of established policies and
- ✓ A financial year planner

Financial systems design must also cater for the two distinct, but interdependent 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 organization. Financial accounting is a system of recording, classifying and summarizing information for various purposes.

Financial accounting records can be maintained either using a manual or computerized 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 organization. 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.

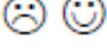
### **Management Accounting**

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:

-  Records transactions
-  Classifies transactions
-  Reconciles records
-  Summarises transactions
-  Presents financial data

### Management Accounting:

-  Compares results against goals
-  Determines reasons for variations
-  Helps identify corrective action
-  Forecasting & planning
-  Analyses information

They must be produced on a regular basis – usually monthly or quarterly depending on the needs of the organization – 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 (e.g. department, branch, function). Organograms are useful here.
- ✓ **Activities** of the organization – 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 organization?
- ✓ **Resources** of the organization – 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 organizing 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).

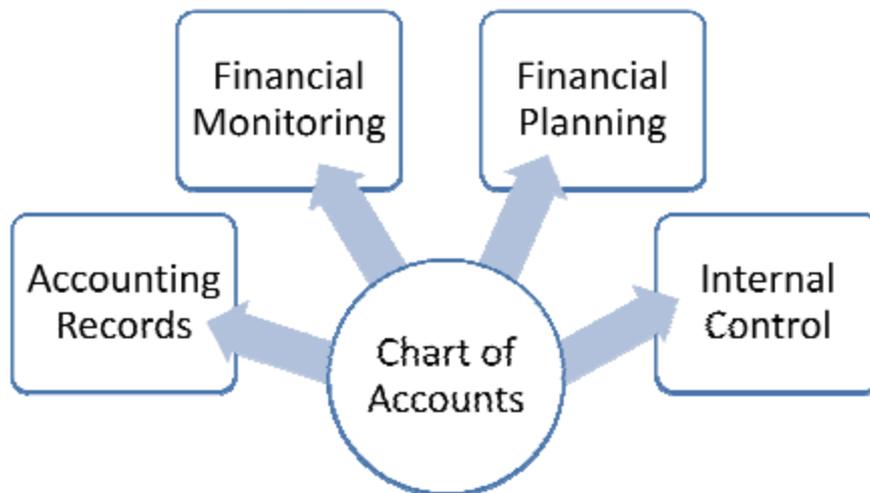
Then, when a transaction takes place, it is recorded in the books of account and categorized according to the guidance held in the Chart of Accounts. The same categories are used in the organization’s budget and financial reports, so promoting consistency and transparency.

Each organization’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 summarized 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 Centers

Some grants are given for a specific purpose they may only be used for a particular activity, rather than for general purposes. Such funds must be accounted for separately so that the organization can demonstrate to the donor how the funds have been utilized. This is known as setting up accounting systems to identify and separate the necessary information.

In such circumstances it may be appropriate to identify activities within an organization by Cost Centre (or Activity or Budget Centre). Cost centers 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 organization chart and donor funding agreements.

### Example

ABC has three departments: Coordination (i.e. management, administration and governance), Workshop Department and Fund Raising Department. The Workshop department in turn has two separate activities with their own funding sources: the Furniture Project and the Vehicles Project.

There is no effective limit on the number of cost centers 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 centers used?

With cost centers in place, when financial transactions are entered into the accounting records not only are they categorized 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 organization, 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 organization 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 organizations 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 a set of principles and guidelines for a key area of activity within an organization. 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 organization 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?***

1. It is fair and realistic
2. It covers all situations likely to arise
3. It meets legal requirements
4. It is affordable for the organization

### ***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 authorization 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 decentralization 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 programs are delivered, it makes sense to include program 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 (e.g. 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 programs 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 (i.e. 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

- ☞ Organization 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 than 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 Appendix 18 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 authorized; or
- ☞ financial information is being summarized or reconciled.

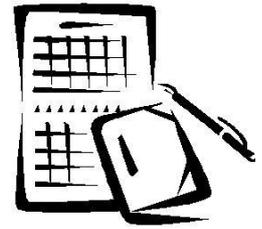
**A note of caution** in the use of standard forms: do not overdo the paperwork as too much bureaucracy slows down the accounting process and overloads the authorization routines.

Some typical uses for standard forms:

- ☞ Payment Voucher Purchase Order
- ☞ Travel and Subsistence Expenses claim Assets Register
- ☞ Vehicle Log
- ☞ Bank Reconciliation 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** – e.g. recording, reconciling and trial balance

**Reporting schedules** – especially to meet donors' requirements

**Budgeting** process

**Reviews** – e.g. assets register, finance manual and insurance cover **Year**

**end procedures** – e.g. preparation for audit

One of the best ways to do this is to use a yearly planning chart. This helps to schedule tasks and allocate tasks to staff so that deadlines can be met.

# Chapter Three

## Financial Planning

This chapter: *'Failing to plan is planning to fail.'* (Chinese Proverb)

- 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 tools 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

“If you don’t know where you are going then you are sure to end up somewhere else”

Mark Twain

and forecasts. It lies at the heart of effective financial management.

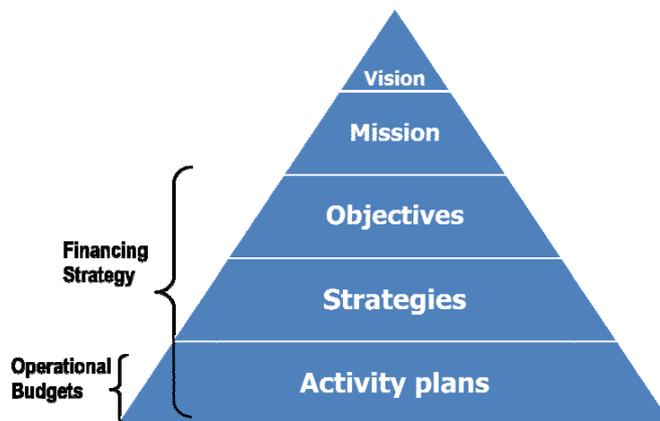
Financial planning does not start with budgets and numbers. Effective budgets can only be produced as a result of good underlying plans. It is impossible to start a financial forecast without a clear idea about what it is you want to do and how you intend to do it.

### 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 organization – 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 organization in a few, general, sentences.

### **Objectives**

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

### **Strategies**

Strategies (also known as Specific Objectives) set out how the organization 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, realistic and time-bound

Once plans are set, the organization draws up its budgets and cash flow 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

‘A budget describes an amount of **money** that an organization **plans** to raise and spend for a set **purpose** over a given period of **time**.’

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 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 organization 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 organization 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 Cash flow Forecast

The income and expenditure budget sets out the anticipated running costs (also referred to as recurrent costs) of the organization and shows where the funds will come from to cover the costs. The annual income and expenditure budget is often broken down into shorter periods – quarterly, half yearly or even 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 organization’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 Cash flow 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 cash flow 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 organization 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 organization is covering its costs over the whole year, the cash flow forecast shows whether it has sufficient cash in the bank to meet all of its obligations needs as they arise. This then 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 program as agreed with your donor
- ✓ Borrowing money from the bank will attract bank charges and interest.

The cash flow forecast is also useful where the organization maintains substantial cash reserves which need to be invested wisely to maximize investment income.



## How to prepare a cash flow forecast

To prepare a cash flow forecast, you will need all of the organization'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 Cash flow Forecast**

1. Cash flow forecasts are not simply the budget broken down into 12 equal installments - 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 cash flow 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 cash flow forecast (eg donations in kind or depreciation) so if these are on the budget, they have to be left off the cash flow.
7. If there is not enough money in the bank to pay for project activities, delays will follow and donors will get upset – so cash flow forecasting is really important!

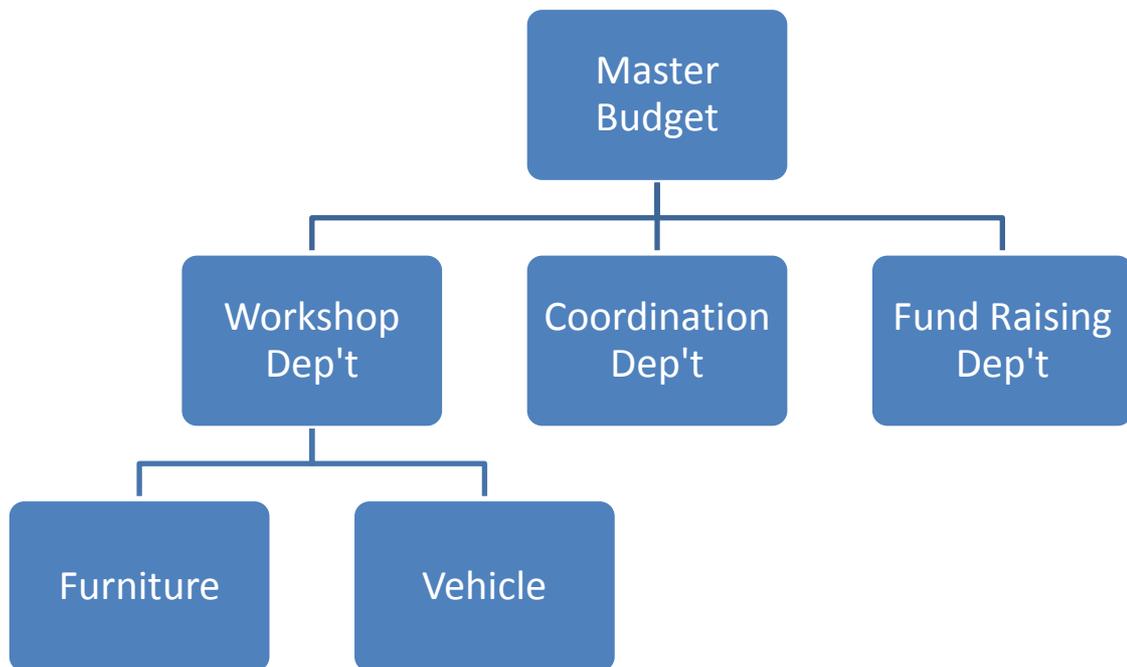
## Budget Structures

To facilitate planning and to enable control to be effective, many organizations try to ensure that the overall structures of their budgets correspond closely to the organization structure. It is possible to organize budgets at different levels, eg by department, program 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 overall budget.

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: ABC Company'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 organizations 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**

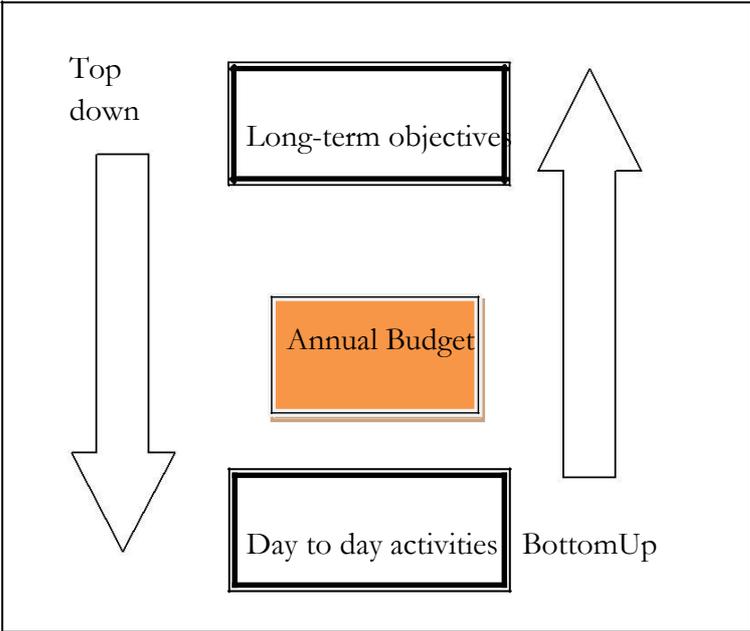
An alternative approach is to start with a clean sheet – a zero base. Zero-base budgeting (or ZBB) ignores previous experience and starts with next year’s targets and activities. ZBB requires the writer of the budget to justify all the resource requirements.

This process may suit organizations 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 is a special form of ZBB and is frequently used in the NGO sector to create project budgets.

**Top Down or Bottom up?**

Figure 3.3: Top Down vs. Bottom up



Since a budget is a financial plan that relates directly to the activities of the organization, 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 organizations employ a mix of top down and bottom up approaches.

## Summary of Budget Terminology

MAIN TYPES OF BUDGET	<b>Income &amp; Expenditure</b>	This budget lists all items of incoming funds and recurrent (ie regularly occurring) costs for a specified period.
	<b>Capital</b>	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.
	<b>Cash flow forecast</b>	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	<b>Balanced</b>	This budget shows that anticipated income is the same as anticipated expenditure
	<b>Deficit</b>	This budget shows that anticipated income is less than anticipated expenditure
	<b>Surplus</b>	This budget shows that anticipated income is more than anticipated expenditure
APPROACHES TO WRITING A BUDGET	<b>Incremental</b>	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
	<b>Zero-base</b>	This describes an approach to budgeting where the budget is built from 'scratch', and not based on previous budgets or figures.
	<b>Activity based</b>	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	<b>Master</b>	This budget shows overall anticipated income and expenditure for the whole organisation for the year.
	<b>Consolidated</b>	This brings together several project or programme budgets in a table to show a summary of each <u>and</u> the total overall.
	<b>Project or programme</b>	This budget shows income and expenditure for a specified project or programme for the implementation period.
TIME PERIODS	<b>Multi-year</b>	This budget outlines anticipated income and expenditure, or cashflow, for two or more successive years.
	<b>Phased</b>	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	<b>Donor</b>	This budget is produced in the format required by a funding agency and usually accompanies a funding proposal.
	<b>Flexible (or variable)</b>	This budget is regularly reviewed and updated to take account of changes in levels of activity
	<b>Funding grid</b>	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.
	<b>Rolling</b>	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 organized 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 realizing, as the example below demonstrates.

Example: Kebe goes to the Cinema

It is Friday afternoon and a teenage son – Kebe – rushes in from school asks his mother for 100 Br. 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 100 Br.

He says he will take the train into town, have a burger and then go to the cinema. His mother then took him through the budgeting process, as follows:

**Objective:** To have an entertaining evening with friends.

**Activities:** Train journey to town, visit burger bar, visit cinema, Train journey home.

**Resources:** Money to cover the costs of train fares, burger, cinema ticket and popcorn.

	\$	
Travel	15.00	2 x 7.5Br Train fares
Food	45.00	35 Br. for burger, 10 Br for popcorn in cinema
Tickets	<u>20.00</u>	
TOTAL	80.00	

Kebe's mother decides that the plan is a reasonable one but gives him 80.00, not the 100.00 he originally asked for.

The next day.....

On Saturday morning, Kebe's mother asks how he enjoyed the evening. He reports that the film was very good 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 burger bar, Kebe and his friends arrived at the cinema to find that all the 20.00 Br seats were sold out and they had to spend an extra 10.00 Br each on the more expensive seats.

This meant that Kebe did not have enough money left to buy popcorn in the cinema or to get the bus back home again. Fortunately, he met the parents of some school friends in the cinema lobby and they offered to give him a lift home after the film, 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 is key 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 organization 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 organization, 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 a simple matter to produce a summarized 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

### **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 5-day workshop for 20 participants with two trainers.

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**

<b>A</b>	<b>B</b>	<b>C</b>	<b>D</b>	<b>E</b>	<b>F</b>	<b>G [D*E*F]</b>
<b>Ref.</b>	<b>Description</b>	<b>Unit type</b>	<b>No. Unit</b>	<b>Qty</b>	<b>Unit Cost</b>	<b>Total cost</b>
1	<b>Workshop costs</b>					
1.1	Room hire for workshop	Days	5	1	250	1,250.00
1.2	Trainers' fees	Days	5	2	300	3,000.00
1.3	Trainers' accommodation	Nights	6	2	100	1,200.00
1.4	Lunch & refreshments	Delegate	22	5	50	5,500.00
1.5	Course handbooks	Delegate	22	1	40	880.00
1.6	Folders for papers	Trainee	20	1	10	200.00
<b>Sub Total</b>						<b>12,030.00</b>

Other typical columns (not shown in the example above) include 'Notes' and 'Account 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 trainers).



- 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 5 days as it is a 5-day course. In line 1.3, we need to provide accommodation for 2 trainers. 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 Br. 50.00 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 5 days at Br. 50.00 per delegate costs \$5,500.00 [22 x 5 x 50]
- 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 organization'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 below for a checklist to help you choose a unit type.

Table 3.3: Choosing Unit Types

Typical Budget Items:	Examples of Unit Type:
<b>Personnel Costs</b>	
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
<b>Transport costs</b>	
Fuel & lubricants	Kilo-meter, month
Vehicle insurance	Month or lump sum per quotation
Vehicle maintenance	Kilo-meter, month
Air fares	Trip/journey
Bus/taxi fares	Trip, month
Distribution costs	Kilo-meter, trip, month
<b>Program administration</b>	
Office rent, electricity and water	Month
Office insurance	Month or lump sum per quotation
Telephone & fax	Month
Office stationery	Month
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
Training materials	Trainee, or specify per item
Professional fees (eg facilitator)	Days
Accommodation	Night
Food	Person, meal, day
Training materials	Trainee, or specify per item

### Summary: What makes a good budget?

Anyone could pick it up and use it to manage their activities:

- Easy to read
- Calculations are clear
- Fully-costed, justified and accurate
- Explanatory notes are provided
- Suitable for purpose
- Appropriate level of detail for the user

## The Challenge of Multiple Donor Program

When a program 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 program budget is detailed in column 1.
- ✓ Donor budgets are entered in the next columns and reconciled to the overall project or program 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 –ABC Project (extract)

		<b>ABC's Confirmed Funding</b>					
		RESTRICTED FUNDS			UNREST'D FUNDS		
<b>Budget Item</b>	<b>Total Budget</b>	<b>DFID</b>	<b>USAID</b>	<b>NIH</b>	<b>General Donation</b>	<b>Total expected funds</b>	<b>Surplus/ (deficit)</b>
	<i>USD</i>	<i>USD</i>	<i>USD</i>	<i>USD</i>	<i>USD</i>	<i>USD</i>	<i>USD</i>
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	<b>2,800</b>
<b>TOTALS</b>	<b>271,300</b>	<b>90,000</b>	<b>90,000</b>	<b>21,000</b>	<b>45,700</b>	<b>246,700</b>	<b>(24,600)</b>

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, ABC appears to be USD 24,600 short of the funds it needs.

However, ABC 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, ABC 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 Four

## 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 organization:

#### Information

All organizations 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 organization 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 organization 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 computerized 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 – so 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 organization.
- The system cannot record non-cash transactions such as a donation in kind or depreciation.

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

## Accruals Accounting

This involves ‘double entry’ bookkeeping which refers to the dual aspects of recording financial transactions to recognize 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 recognizing 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 summarizing all income and expenditure committed during a given period; and a Balance Sheet which demonstrates, amongst other things, moneys owed to and by the organization 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 summarized 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.

### ***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 organization 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 organization 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 organizations 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.

<hr/> <b>RECEIPTS</b> <b>EXPLAIN:</b> <hr/>	Apart from being required by the external auditor to support the audit trail, certified receipts also provide protection to those handling the money. Mislaidd or incomplete records can result in suspicion of mismanagement of funds.
<hr/> When? <hr/>	Keep separate files for receipts for money coming into the organization and money going out. Mark invoices 'paid' with the date and cheque number to prevent their fraudulent re-use by an unscrupulous person.
<hr/> How Much? <hr/>	
<hr/> What? <hr/>	
<hr/> Who? <hr/>	
<hr/> Why? <hr/>	

**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.

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 totaled 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 summarize transactions by budget category which in turn helps to compile financial reports quickly and easily.

Figure 4.1: Typical Bank Book layout

LEFT SIDE										RIGHT SIDE										
Receipts of Money Into The Bank										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 organization’s own records agree with the bank’s records and to pick up any errors made by the bank or the organization.

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.

### **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.

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, Br.500 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:	346
Cash remaining in cash box counted::	<u>154</u>
TOTAL FLOAT:	500

∴Reimbursement check written for: Br. 346

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 analyzed Bank Book.

## 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

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

### ▪ 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 organization 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 organization.

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 familiarize yourselves with the arrangements of your own Department of Taxes and get hold of the latest tax deduction tables.

Larger organizations 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 summarizing stages, the total of debit balances on the list will equal the total of the credit balances.

Figure 4.2: Trial Balance leading to financial statements

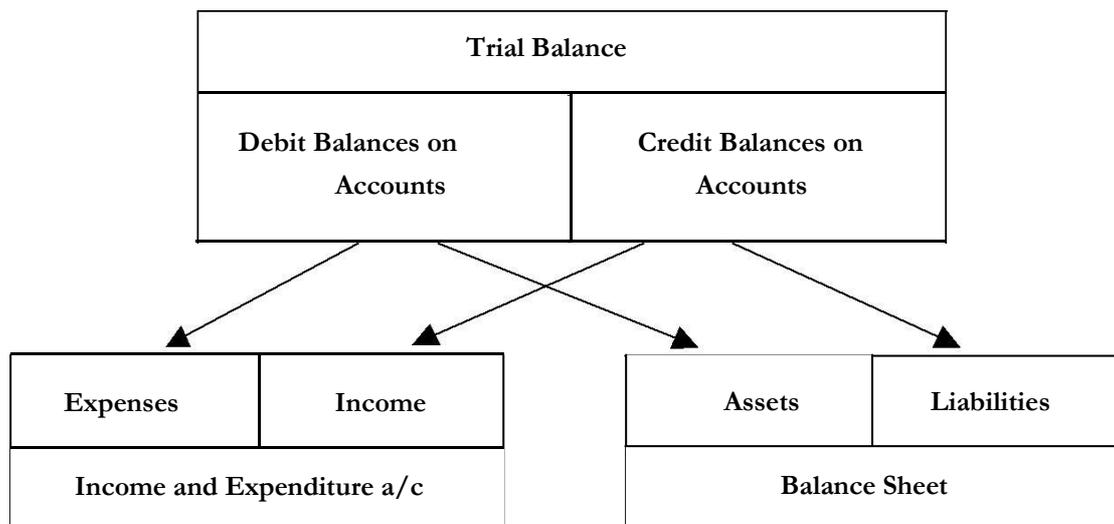
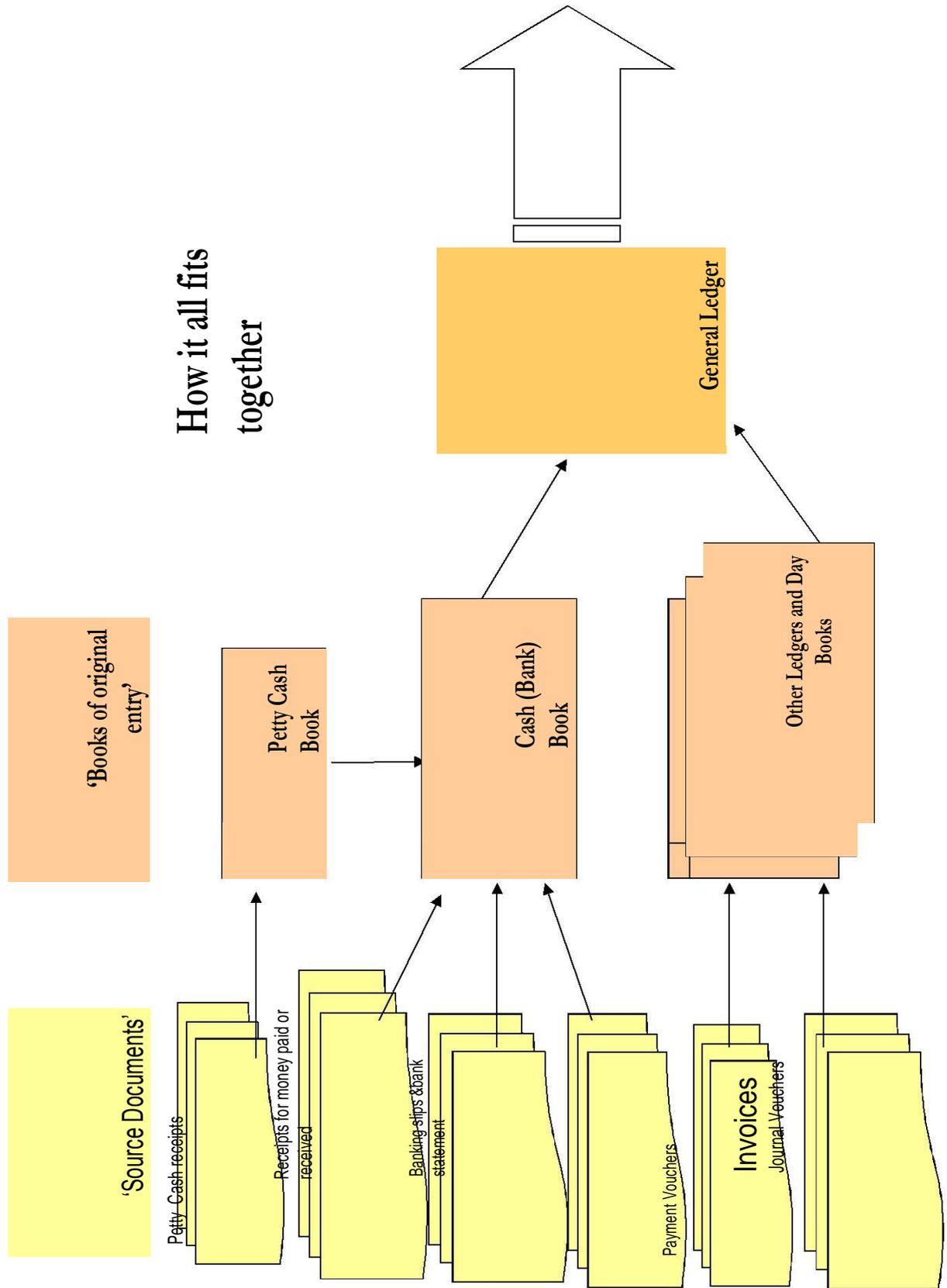


Figure 4.3 shows how the Trial Balance is the final stage of the accounting process – the result of recording, classifying and summarizing the many different transactions that take place in an organization. Figure 4.2 illustrates which figures from the Trial Balance end up where in the annual financial statements.

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 organization.

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 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 analyze 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).

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 organization at a given date. If the organization 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 organization was ‘worth’.



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 organization.

### ▪ 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 organization – 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 organization 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 organization has available as a cushion or safety net for running the organization's operations.

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

**Table 4.2 Components of a Balance Sheet**

<b>Component:</b>	<b>Description:</b>
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 organization 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 organization 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 organization 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 organization's General Funds.
- Accumulated Funds	Accumulated surplus of income over expenditure achieved since the organization 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 organization.

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).

Depreciation schedule

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

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

## Accounting for Shared Costs

Core costs are usually shared out between cost centres in a pre-arranged ratio. This can either take place as the transaction is 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 centers can be based on different criteria according to what is known as the cost driver, for example:

- ◆ Number of employees in the projects
- ◆ Number of cost centers
- ◆ Size of each project budget
- ◆ Project staff costs
- ◆ Amount of space used by department
- ◆ Number of clients/beneficiaries
- ◆ Actual consumption, eg kilometers travelled, photocopies made.

There is no hard and fast rule for allocating overheads to projects; rather logic should be applied and the criteria chosen should be justifiable.

For example, in allocating central support staff salaries to projects, the number of employees in the project could be used; and for apportioning the cost of office rent, the actual space occupied by project staff is applicable.

Whatever method is chosen, it must be fair and justified, and once established it should be applied consistently.

# Chapter Five

## 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.

<b>Stakeholder</b>	<b>Why do they need it?</b>
<b>Project staff</b>	To know how much money and resources are available for their projects and what has been spent so far.
<b>Managers</b>	To keep an eye on how project funds are being used, especially compared to the original plans. To help plan for the future.
<b>Finance staff</b>	To make sure that there is enough money in the bank to buy the things the NGO needs to run its programmes.
<b>Board of Trustees</b>	To keep an eye on how resources are being used to achieve the NGO's objectives.
<b>Donors</b>	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.
<b>Government departments</b>	To make sure that the NGO pays any taxes due and that it does not abuse its status as a 'not for profit' organisation.
<b>Project beneficiaries</b>	To know what it costs to provide the services they are benefiting from and to decide if this is good value for their community.
<b>The general public</b>	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 summarized in Table 5.2 below.

- During the financial year accounting information is summarized 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

### **What are the Annual Accounts?**

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

- Ω Where money has come from;
- Ω For what purpose it has been received;
- Ω How it has been spent; and
- Ω 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:

- Ω Present the organisation in the best possible light;
- Ω Help to promote its work;
- Ω Meet the needs of those using the accounts; and
- Ω 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 organizations, 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 organizations 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 organizations 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?

## Analyzing 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.

## Analyzing 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 organization'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:
<b>1. Donor Dependency:</b> Expressed as %	$\frac{\text{TOTAL DONOR INCOME}}{\text{TOTAL INCOME}} \times 100$
<b>2. Income Utilisation:</b> Expressed as %	$\frac{\text{EXPENDITURE ITEM}}{\text{TOTAL INCOME}} \times 100$
<b>3. 'Survival Ratio':</b> Expressed in weeks or days	$\frac{\text{GENERAL RESERVES}^*}{\text{TOTAL INCOME}} \times 52 \text{ or } \times 365$ <p>* these are un-restricted funds for general purposes under Accumulated Funds. Alternatively use Net Current Assets.</p>
<b>4. Acid Test or Liquidity Ratio:</b> Expressed as a ratio n:n*	$\frac{\text{CURRENT ASSETS} - \text{PREPAYMENTS}}{\text{CURRENT LIABILITIES}}$ <p>*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.</p>
<b>5. Current Ratio:</b> Expressed as a ratio n:n*	$\frac{\text{CURRENT ASSETS}}{\text{CURRENT LIABILITIES}}$ <p>*A result of 2:1 is considered satisfactory – enough to pay off the debts within 12 months.</p>

## 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.

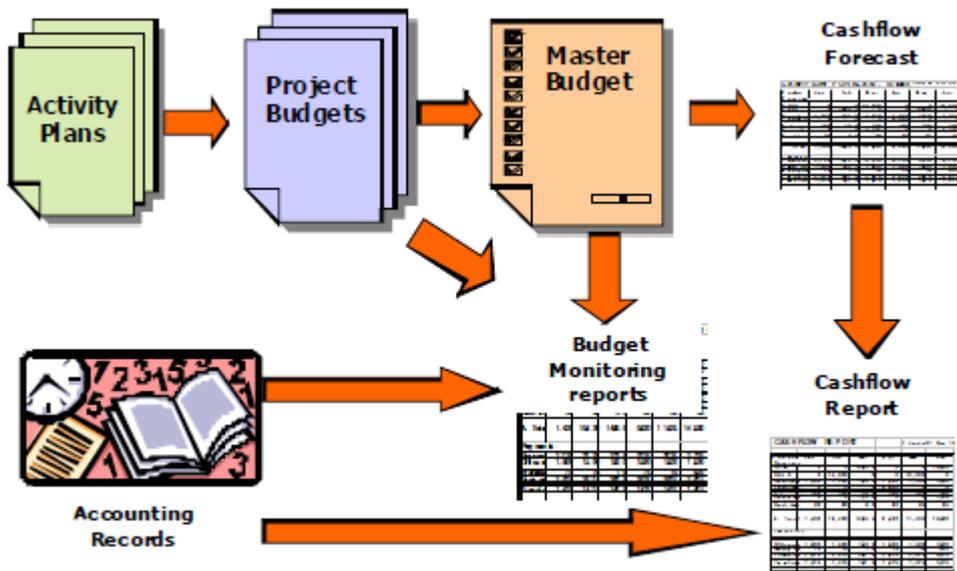
Since the reports are produced so that managers can take decisions about the future management of the organisation, the meetings of the governing body should be set to coincide with the Management Accounts cycle so that the information is still timely.

**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 summarized 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:

- Cash flow Report
- Budget Monitoring Report
- Forecast Report

## The Cash flow Report

The cash flow report is the cash flow 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 cash flow 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 installment – eg insurance premiums
- Priorities 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.

The difference between the budget and the actual result is known as the variance 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 utilization ratio or the burn rate (see below for how to calculate percentages.)

We can see the Plan-Do-Review process in action in Kebe's trip to the Cinema. 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.

For example, we can see the effect of Rudi arriving too late to buy the cheaper cinema 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 fulfill the plans and build in that learning to the next cycle.

In Kebe's case, he learnt that he needs to get to the cinema early 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!)

## 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.

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.

## Analyzing 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 or programme? 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 overspending- 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?

## 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 favorable (ie generally good news) and negative ones as adverse (ie generally bad news):

A **favorable 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.

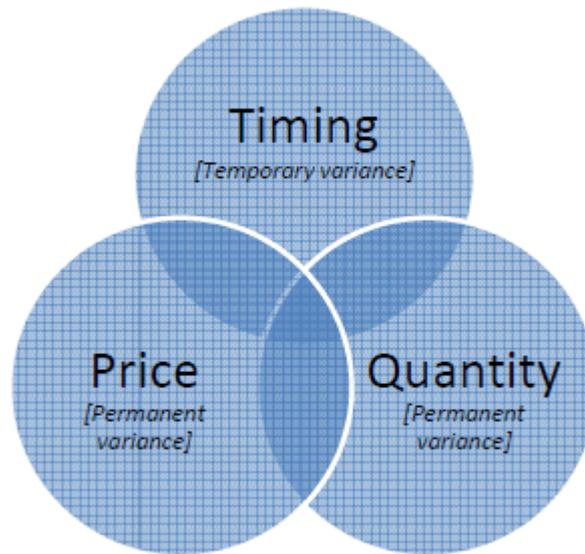
The next step is to understand what has caused the variance to happen. In all cases, a variance represents a change from the original plan but what lies behind it? Generally, we can say that variances will be the result of a change in one or more of:

- 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.



**Figure 5.2: What causes variances?**



We classify variances using the three criteria 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**

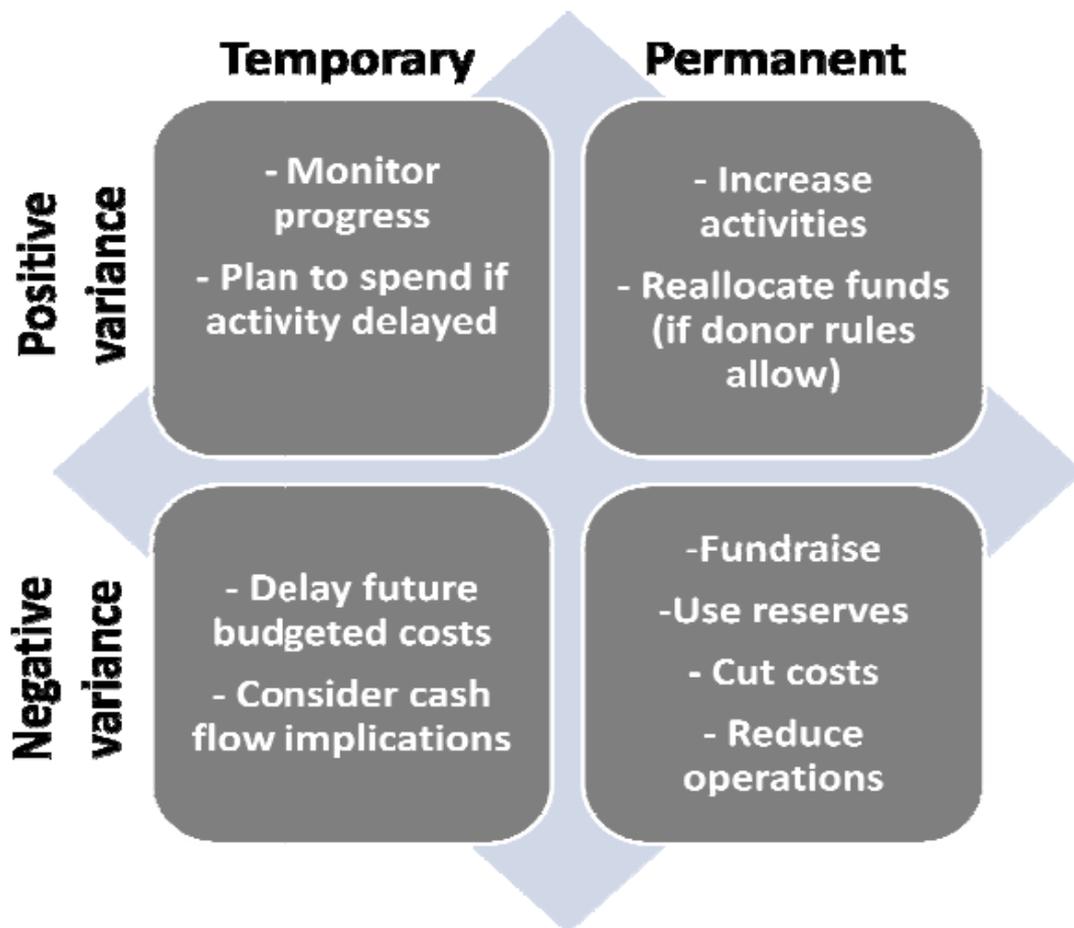
The invoice for the vehicle is paid in month 3. The price of the vehicle has increased by 10% due to a fluctuation in the exchange rate.

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

**Figure 5.3** summarizes the actions open to managers to take on variances, once analyzed using the classifications systems described above.

Figure 5.3: Action to take on Variances



**Action Planning**

Having analyzed the figures in management reports, it is then important to work out appropriate corrective action, if needed. 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 programs 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

<b>Budget Management – Action Planner</b>					
1	2	3	4	5	6
Line Item description	Variance % or £/\$	Variance Type	Controllable?	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 installments.
- ◆ **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 Centers 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 fully 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:

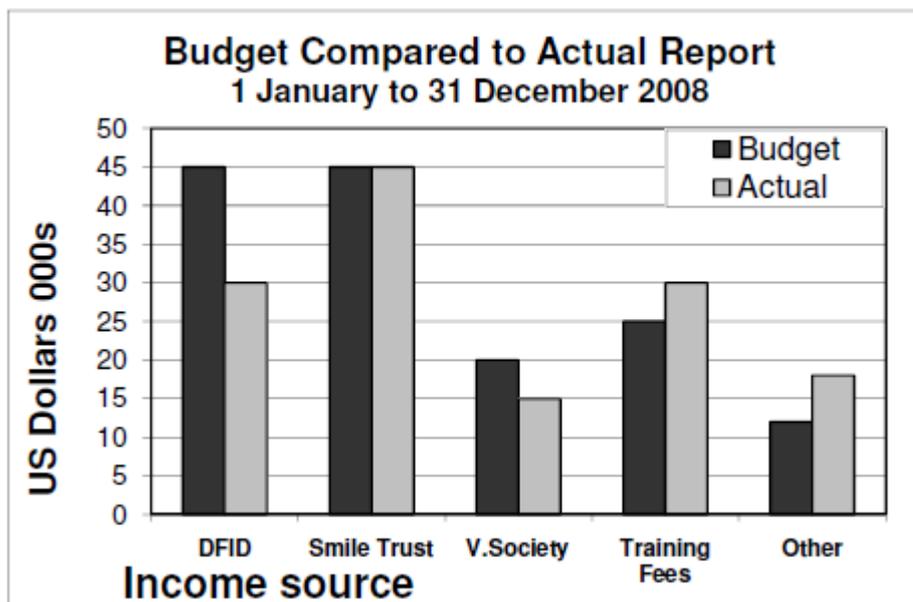
- **Overview** of the period being reported – ie dates covered; how figures have been compiled; what activities are covered by the attached reports; and author of report.
- **Significant variances** - Highlight the most significant variances from the budget and explain the reasons behind the variances. This should not just concentrate on overspending 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 cash flow 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

Figure 5.4: Using graphics for financial reports



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.

## Reporting to Beneficiaries

Most NGOs recognize 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 program 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

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.

# Chapter Six

## 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 organization 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

## **Delegated Authority**

The Board of Trustees delegates authority through the Chief Executive for the day-to-day running of the organization. In a large and busy organization it is not practical to expect one person to make all the decisions and authorize 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 organization 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 organization 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:

1. Placing and authorizing orders for goods and services
2. Signing Checks
3. Authorizing staff expenses
4. Handling incoming cash and checks
5. Access to the safe and petty cash
6. Checking and authorizing accounting records
7. Signing legal undertakings

The Delegated Authority document must be approved by the governing body and should be reviewed every year to ensure it is still appropriate to current needs. It should also outline

deputizing arrangements to cover for absence of key personnel. A breach of delegated authority is a serious matter and should be dealt with accordingly.

### **Authorization rules**

When writing a delegated authority document there are some basic rules which should be observed:

- ☞ **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 authorize any transaction from which they will personally benefit. This makes the individual vulnerable to accusations of abuse.
- ☞ **Sub-ordinates must not authorize payments to managers** – they must be passed to someone who is more senior in the management structure.

Any limits or conditions that apply to delegated authority must be clearly defined. For example, a person may be authorized 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 misuse funds, there must be a separation of the various duties within the finance procedures.

For example, the duties of ordering goods, receiving goods, authorizing 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 organization 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/or committee 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 organization 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 (e.g. salaries) or suppliers' accounts (e.g. stationery, petrol);

- clarify when it is necessary to obtain quotations from suppliers – e.g. 2 quotations for all expenditure over \$100;
- include a list of Approved Contractors or Suppliers, if used.

### Signing checks

Each organization should have a panel of Check signatories from which to select the required number of authorizing 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 organization.

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

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

### Checking and authorizing accounting records

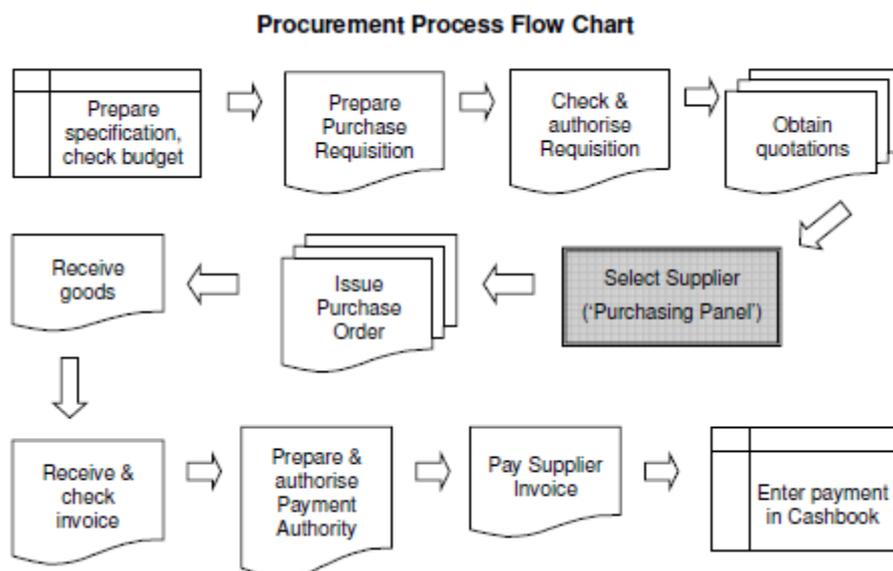
A key responsibility of managers (the Chief Executive or Financial Controller in a larger organization or a Treasurer in a smaller one) is to check and authorize records, count the petty cash and review orders for supplies, from time to time.

### The Procurement Process

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

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

**Figure 6.1 Typical Procurement Process**



### **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. Authorize Purchase Requisition**

The purchase requisition will usually be checked and authorized 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 organization gets best value for money and to minimize 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 Purchase Order (PO)**

A 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 Authorize 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 authorized 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 organization's books of account.

## 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. 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 organization'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.

### 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 (i.e. what the organization paid the T-shirts supplier) and the resale value (i.e. what the organization 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

<i>Particulars</i>	<i>Cost Value (Birr)</i>	<i>Resale Value (Birr)</i>
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:

1. The value of new purchases could be wrong – e.g. 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.
2. The value of sales could be wrong – e.g. the wrong amount could have been charged or a sale not recorded or coded properly.
3. Stock could have been stolen.
4. 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 would have to be investigated and systems reviewed if necessary. This demonstrates well the importance of regular stock reconciliation.

### **Wages Book**

The wages records, and particularly deduction records, are notorious for containing inaccuracies and for abuse in the form of ‘ghost employees’ (i.e. 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 organization 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 organization 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 authorized 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. Every attempt should be made to pay cash into the bank on a daily basis or, at the very least, within 3 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 authorized individuals. This should be recorded in the organization'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 Check. The advantage of paying for most transactions by Check 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 authorized 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 organization.

### **Having a safe**

Having a safe – or a safe place – to keep cash, checks books, legal documents, etc. is an important consideration. A proper safe is worth considering especially if your organization 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, flood 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 18 (page A22) for a sample Assets Register record sheet.

### **Building and Equipment Maintenance policy**

To preserve the value of buildings and equipment, an organization 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 organization 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.

Vehicle make/model:	Toyota Hiace Van	
Date purchased:	26 December 2014	
Purchase price:	\$20,000	
Depreciation period /method:	5 years, straight line method	
Maintenance:	Service every 6,000 km or every 3 months	
KM run	<i>From 1 January to 31 December 2015:</i> Km on clock on 31/12/15 LESS Km on clock on 01/01/05 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, tires, etc	900
4. Insurance and tax		
	Insurance, road tax for the year	3,300
<b>TOTAL VEHICLE RUNNING COSTS:</b>		<b>13,700</b>
Cost per Km calculation:		\$0.67
	Total costs for the year = 13,700.00	
	Total no. of Km run = 20,400 km	

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

## Top Tips on the Warning Signs of Fraud

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

The following ideas may 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 – i.e. 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 – i.e. deliberately delayed so managers cannot detect false accounting going on.
- ❖ Missing supporting documents – e.g. certain bank statements destroyed to cover someone’s tracks, or a project officer who regularly claims to have ‘lost’ receipts.
- ❖ Debtors rising unexpectedly – e.g. 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 behavior between line items – e.g. 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?

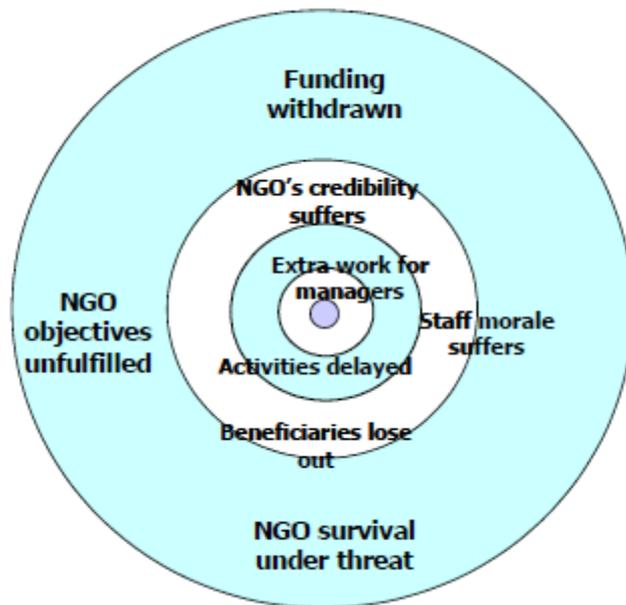
**Non-financial areas:**

- ❖ Working very long hours – first in last out of the office? Could mean that they are having to do extra work to cover 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 (e.g. 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.
- ❖ Hold regular meetings with other staff at all levels (e.g. 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 taking trainings such as this one.

**Figure 6.2: The Ripple Effect of Fraud**



## 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 defined as: a deliberate, improper action which leads to financial loss to the organization. This 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 unauthorized activities for private gain: e.g. ‘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 organization. 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 above illustrates.

Incidents of fraud and irregularities require sensitive handling to minimize 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 organization 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 organization'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 organization'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 rumors to spread or let the 'trail' go cold.

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.

### **Summary**

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

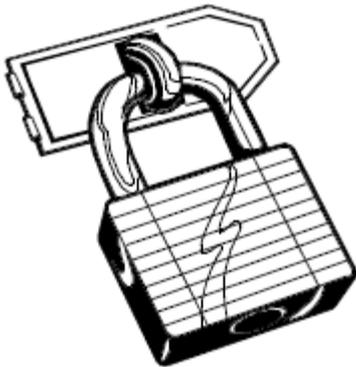
DO

- ☞ **R**eport the incident to a superior or Board member
- ☞ **I**nvestigate incidences, gather the facts
- ☞ **S**ecure the assets and records
- ☞ **K**eep calm!
- ☞ **S**wiftly act

#### DON'T

- ☞ **L**ook the other way
- ☞ **O**verlook the 'fall out' of a fraud
- ☞ **W**ithhold information to protect others

Above all, remember that prevention is better than cure!



## Chapter Seven 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, i.e 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:

- Ω **Economy:** paying no more than necessary for the resources needed.
- Ω **Efficiency:** getting the greatest benefit with the fewest resources.
- Ω **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 recognized 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?**

**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

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.

**‘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.

## 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.)

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 summarizes 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, e.g. 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 organizational strengths and weaknesses.

### **Summary: Different Types of Audit**

<b>Area</b>	<b>Internal</b>	<b>External</b>	<b>Donor/Project</b>
<b>Main purpose</b>	Check effectiveness of systems & procedures	Verify the published accounts give a 'true & fair' view	Check that funds used in accordance with the funding agreement.
<b>Focus of review (starting point)</b>	Systems and Procedures manual	Financial Statements and Underlying records	Grant Agreement
<b>Appointed by</b>	Management (but have direct line to the board)	Board (members)	Donors
<b>Scope</b>	As per planned schedule based on risk assessment. May be for a specific department, grant or period	All financial transactions in the accounts, whole organization	Usually limited to the project and related grant funding
<b>Report Includes</b>	Findings and recommendations for improvement	Auditor's opinion and management letters	Usually auditor's opinion and recommendations
<b>Employed by</b>	The NGO or external body (outsourced)	External Body	External body (Donors)
<b>Qualifications</b>	No formal requirement	Must be qualified and registered accountant	Usually qualified and registered accountant

## 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 is given as follows.

### An Auditor's Checklist

Group of Records	Description of Items
<b>A. Primary records of accounts</b>	✓ 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>B. Summaries and reconciliation statements</b>	✓ 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
<b>C. Schedules:</b>	✓ 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
<b>D. Other information:</b>	✓ 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

