

Financial Management

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1 Introduction

The purpose of this chapter is to explore some of the key aspects of financial management that are relevant and important for non-governmental organisation (NGOs) today in managing donor-funded projects. The following four key areas of financial management are examined for the purpose of this chapter:

Area 1: Budget Management

Area 2: Financial Reporting

Area 3: Assessing an NGO partners' financial management capacity

Area 4: Audit and Control

The first part on budget management analyses some of the key criteria used by donors in appraising donor-funded projects, with a particular focus on the requirement of NGOs to link project proposals' budget components to the project plan. The chapter also examines the requirement of donors for NGOs to effectively manage and control their budgets through effective variance analysis and reporting. The human aspects of budget preparation and budgetary control are also examined.

The second part discusses where the responsibilities of NGOs lie in terms of financial reporting, including examining the key users of financial reports and the key financial reports required by donors.

The third part analyses the rationale behind NGOs assessing the financial capacity of their partners. This section of the chapter will also examine how NGOs can use a financial management health check toolkit to facilitate this task.

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The final part of the chapter explores a number of key aspects associated with effective audit and control, particularly the relationships between corporate governance risk management and internal controls.

2 Budget Management

According to Jacobs Alex et al., there is an increasing awareness that management techniques are crucial to project success in NGOs.¹ Generally, private NGOs have either a community or an environmental focus. They address a variety of issues such as religion, emergency aid or humanitarian affairs. They mobilise public support and voluntary contributions for aid, often have strong links with community groups in developing countries and usually work in areas where government-to-government aid is not possible. NGOs are accepted as a part of the international relations landscape, and while they influence national and multilateral policymaking, they are increasingly involved directly in local action.

All NGOs, irrespective of size, need budgets to operate, with amounts differing between organisations, as Mbugua states.² Unlike the budgets of smaller NGOs, those of larger NGOs may number in the hundreds of millions or billions of dollars or euros.

Keeping such large budgets afloat demands significant fundraising efforts on the part of most NGOs. Major sources of NGO funding include membership dues, the sale of goods and services, grants from international institutions or national governments, such as EU grants and private donations. Several EU grants provide funds accessible to NGOs. Although the term NGO implies independence from governments, many NGOs depend heavily on them for their funding.

2.1 Overhead

Overhead is the amount of money that is spent on running an NGO rather than on specific projects. It includes office expenses, salaries, banking and bookkeeping costs.

The percentage of overall budget spent on overhead is often used as a criterion to assess the soundness of an NGO's inner workings, with less than 4% viewed as very favourable.

The World Association of Non-Governmental Organisations, for its part, states that ideally more than 86% of funds should be spent on programmes (with less than

¹Jacobs et al. (2004).

²Mbugua et al. (2008), <http://www.securethefuture.com/Shared%20Documents/resource/financemng.pdf>.

20% allocated to overhead). The Global Fund to Fight AIDS, Tuberculosis and Malaria has developed specific guidelines for orientation on how high the level of overhead may be in order to qualify for funding. In many cases, overhead needs to be less than 5–7%. An elevated percentage of overhead as compared to total expenditures can make it more difficult to generate funds. High overhead costs may also generate criticism with some claiming that certain NGOs with high overhead are run simply to benefit bosses and staff instead of the people working for them.

While overhead costs can be a legitimate concern, a sole focus on them can be counterproductive. Research published by the Urban Institute and the Center for Social Innovation at Stanford University has shown how rating agencies create incentives for nonprofits to lower and hide overhead costs, which may actually reduce organisational effectiveness by starving organisations of the infrastructure they need to effectively deliver services. A more meaningful rating system would provide more than financial data, a qualitative evaluation of an organisation's transparency and governance along the following lines: (1) an assessment of programme effectiveness, (2) an evaluation of feedback mechanisms designed for donors and beneficiaries and (3) opportunities for organisations to respond to evaluations by rating agencies. More generally, the popular discourse of nonprofit evaluation should move away from financial notions of organisational effectiveness and towards a more substantive understanding of programmatic impact.

2.2 *Monitoring and Control*

A report by former U.N. Secretary General Kofi Annan in favour of international humanitarian intervention argues that the international community has a 'right to protect citizens of the world against ethnic cleansing, genocide, and crimes against humanity'.³ On the heels of the report, the Canadian government launched the Responsibility to Protect (R2P) project to clarify the issue of humanitarian intervention. While the R2P doctrine has been widely applied, it has also generated a considerable amount of controversy. The latter includes the Canadian government invoking the R2P to justify its intervention and support of the coup in Haiti. More recently, the World Federalist Movement, an organisation that is in favour of *the creation of democratic global structures accountable to the citizens of the world and call for the division of international authority among separate agencies*,⁴ has launched Responsibility to Protect—Engaging Civil Society (R2PCS). A collaboration between the World Federalist Movement (WFM) and the Canadian government, the project aims to bring NGOs into lockstep with the principles outlined under the framework of the original R2P project.

³Previts et al. (2010).

⁴World Federalist Movement, Our Movement, <http://www.wfm-igp.org/our-movement>.

The governments of the countries where an NGO works or is registered in may require reporting or other monitoring and oversight. Donors generally require reporting and assessment, from the NGOs they allocate funds to, as such information is not necessarily publicly available. There may also be associations and watchdog organisations that research and publish details on the actions of NGOs working in particular geographic or programme areas.

In recent years, many large corporations have increased their corporate social responsibility departments in an attempt to pre-empt NGO campaigns against certain corporate practices. According to this reasoning, if corporations work with NGOs, NGOs will not work *against* corporations. Greater collaboration between corporations and NGOs creates inherent risks of the stronger party co-opting its weaker partner, typically the nonprofit involved.

2.3 Linking Budget and Project Plans

Most donors, when evaluating proposals, test whether the project budget is realistic and links logically to the projects' objectives, outputs and activities. The compilation of the budget is usually prescribed by the donors and broken down into categories, including personnel costs, direct programme costs, capital equipment costs and programme support/overhead costs. In order to align the budget with the plan, some unit of measure is used to derive the number of units and use them to calculate the budget by multiplying the number of units by the unit cost. In relation to personnel costs, this budget line heading usually includes all staff associated with the direct implementation of the project, and it is normally broken down to indicate costs associated with local and expatriate staff. In most large donor-funded projects, a clear justification for the use of expatriate staff should be provided.

Examples of direct programme costs could include the cost of supplies and materials for the distribution to individual or groups of beneficiaries, as well as entire project areas, such as procurement, storage and distribution costs, for example medicines, blankets, household items, seeds/tools, etc. Other examples of direct programme costs could include the costs associated with post-conflict reconstruction, including the breakdown of materials and associated labour costs. The cost of in-house training, including in-country workshops and seminars directly associated with project implementation, is seen as direct programme costs and should be appropriately budgeted for.

Under the capital equipment budget heading, the purchase of capital equipment, such as vehicles, computers, faxes, copy machines, is a regular part of the budget. However, organisations must normally justify why equipment is needed and how it is to be used/disposed of after the end of the project. Programme support costs are normally budgeted for and provided by donors particularly where justification is provided. Costs under this budget heading typically include office rent, electricity,

water charges, office supplies, telephone charges, fuel and maintenance and general administration fees. The final key budget line that NGOs look for in donor funding regards management support costs. These are referred to as head office costs and normally should not exceed 6% of the total budget.

3 Budgetary Control

Budgetary control is crucially important for the survival of any organisation, whether in the private, public or not-for-profit sectors.⁵ From both an applicant's and a donor's perspective, effective budgetary control ensures proper accountability, transparency and effective disbursement of donor funds. Budgetary control (often referred to as variance analysis) is a key mechanism to identify over- and underspending and to prepare appropriate action to manage the budget. Some donors (for example, Irish Aid or USAID) require NGOs to provide them with periodic budgetary control reports. These reports usually contain financial information comparing the current budget to actual expenditure for the period assessed and explains and identifies key variances.

4 The Human Dimension to Budget Preparation and Budgetary Control

In order to ensure that NGO budgets are properly prepared, sound financial practice requires guaranteeing that project staff members with the necessary expertise are allowed to participate in the preparation of organisations' budgets. In a nonprofit NGO environment, this process usually enables buy-ins from key project staff and motivates them to manage the budget effectively. Tracy posits that every organisation needs to ensure that project managers and the staff are an integral part of the budgetary process.⁶ Bhimani states that proper feedback on managing budgets is essential for motivating people in organisations.⁷ This can involve providing feedback to staff members verbally and in a written format. According to Reck, people within organisations are most motivated when provided with objective, democratic and participative, constructive feedback as to how they handled the budgets.⁸

⁵Drury (2015).

⁶Tracy (2013).

⁷Bhimani et al. (2013).

⁸Reck (2012).

5 Financial Reporting

The financial reports produced by NGOs provide a summary of their income and expenditure for a particular period. They allow NGOs (and other stakeholders) to monitor their financial position. For instance, they help to evaluate whether an NGO has sufficient monetary assets to pay salaries at the end of each month, complete projects or fund plans for the upcoming year. According to Walton, financial reports have to be timely, accurate and relevant.⁹ They must also be easy to read. So it is always important for NGOs to talk to users about what sort of reports they find easy to use.

NGOs prepare financial reports for different audiences, including managers, trustees, beneficiaries, donors and the government, all of which may have different expectations as to what reports should comprise. Using these reports, NGO staff and donors can monitor whether activities are going ahead as planned (and whether there are enough funds to sustain projects in the future).

Beneficiaries may comment on whether funds are being spent on their real needs, whereas governments and trustees monitor the NGOs' behaviour from a legal perspective.

As financial reports are used by many different internal and external stakeholders, different kinds of reports are needed for different audiences. During the financial year, project managers summarise accounting information and compare it to the budget for internal monitoring. These reports are usually referred to as management accounts and/or variance reports.

At the end of the year, the annual accounts (or financial statements, made up of a balance sheet and income and expenditure statement) report on the outcome for the year. These reports provide information that is historic and are mainly targeted at external stakeholders. During the year, NGOs also provide donor reports to funding agencies. These usually include both financial and written progress reports. In this vein, it is important for NGOs to set up their accounting systems (especially accounting codes) to meet their various reporting needs. Reporting to donors can be complicated if NGOs have to use their own specific formats.

Assessing Financial Management Capacity of Partners Many donors require NGOs (particularly international NGOs) to use local partners to conduct their projects. Therefore, assessing the financial capacity of local partners is crucially important to identify any potential existing weaknesses or risks. The following are examples of best practice financial management areas that NGOs look for when assessing local partners:

- financial health;
- capacity of partner and its staff required to implement the project;
- internal controls and procedures in place;
- no overt reliance on a single donor;

⁹Walton and Aerts (2009).

- communication systems of the local partners;
- links and relationships with beneficiaries, that is, the local communities to whom one wants to deliver aid;
- a valid supporting document for every transaction (securely filed and stored for the minimum period required);
- a cash book for every bank account, reconciled every month;
- a Chart of Accounts—used consistently in the accounting records and budgets;
- a budget detailing costs and anticipated income for all operations;
- clear delegation of authority—from the governing body through the line management structure;
- separation of duties—sharing financial duties between at least two people; and
- annual financial statements—preferably audited by an independent person.

Audit and Control Corporate governance is concerned with managing management.¹⁰ It denotes the system that directs and controls organisations. It is about the structures and processes that are in place at the top of an entity for organisational decision-making, accountability, controls and behaviour. It also refers to the way in which organisations manage their business, determine strategy and objectives and go about achieving them. At the heart of most organisations—private or public—lies the separation of ownership and control and the issues this creates. The Chartered Institute of Public Finance and Accountancy (CIPFA) has defined corporate governance as ‘[t]he arrangements put in place to ensure that the intended outcomes for stakeholders are defined and achieved’.¹¹

Risk is the threat that an event or action will adversely affect an organisation’s ability to achieve its objectives and to successfully execute its strategies. It has also been defined as the chance of something happening that will have an impact on business objectives.

Risk management is the process by which risks are identified, evaluated, controlled and monitored. Risks manifest themselves in two ways: as direct threats (damaging events), which may lead to failure to achieve objectives, and opportunities (constructive events), which if exploited could offer an improved way of achieving objectives but which are surrounded by threats. The essence of risk is the uncertainty of outcome (whether positive or negative). The term exposure refers to the combination of the probability of these potential risks and the magnitude of their impact.

Probability means the evaluated probability of a particular outcome actually happening (including a consideration of the frequency with which the outcome may arise). Lastly, impact is the evaluated effect or result of a particular outcome actually happening.

Table 1 offers a summary of the most common categories of risk that could apply to an NGO with examples of the nature of the source and effect issues. It does not

¹⁰Carlsson (2001).

¹¹IFAC/CIPFA, Independent Framework: Good Governance in the Public Sector, New York/London 2014.

Table 1 Categories of risk

<i>External</i>	
1. Infrastructure	Relating to infrastructures such as transport systems for staff, power supply systems, suppliers, business relationships with partners, dependency on the Internet and e-mail
2. Economic	Relating to economic factors such as interest rates, exchange rates, inflation
3. Legal and regulatory	Relating to the laws and regulations that if complied with should reduce hazards (for example—Health and Safety at Work Act)
4. Environmental	Relating to issues such as fuel consumption, pollution
5. Political	Relating to possible constraints such as change of government
6. Market	Relating to issues such as competition and supply of goods
7. 'Act of God'	Relating to issues such as fire, flood, earthquake
<i>Financial</i>	
8. Budgetary/financial	Relating to the availability of resources or the allocation of resources
9. Fraud or theft	Relating to the unproductive loss of resources
10. Insurable	Relating to the potential areas of loss that can be insured against
11. Capital investment	Relating to the making of appropriate investment decisions
12. Liability	Relating to the right to sue or to be sued under certain circumstances
<i>Activity</i>	
13. Policy	Relating to the appropriateness and quality of policy decisions
14. Operational	Relating to the procedures employed to achieve particular objectives
15. Information	Relating to the adequacy of information that is used for decision-making
16. Reputational	Relating to the public reputation of the organisation and consequent effects
17. Transferable	Relating to risks that may be transferred or to transfer of risks at inappropriate cost
18. Technological	Relating to the use of technology to achieve objectives
19. Project	Relating to project planning and management procedures
20. Innovation	Relating to the exploitation of opportunities to make gains
<i>Human Resources</i>	
21. Personnel	Relating to the availability and retention of suitable staff
22. Health and safety	Relating to the well-being of people
<i>Others</i>	
23. Inter-agency	Relating to work and activities of external bodies
24. Intra-agency	Relating to internal activities and support services

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purport to be comprehensive as some organisations may be able to identify other categories of risk applicable to their work.

Internal Control System It comprises the control environment and control procedures. It includes all policies and procedures (internal controls) adopted by management to assist in achieving their objective of ensuring, as far as practicable,

the orderly and efficient conduct of the organisation's activities, including adherence to internal policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records and the timely preparation of reliable financial information.¹² The board and senior management are responsible for ensuring an adequate and appropriate internal control system.

Control environment means the overall attitude, awareness and actions of the board, management and staff regarding internal controls and their importance within the organisation. It encompasses the management style, corporate culture and values shared by all employees and provides the background against which various other controls are operated. However, a strong control environment does not, by itself, ensure the effectiveness of the overall internal control system. Factors reflected in the control environment include the following:

- philosophy and operating style of the board, management and staff;
- entity's organisational structure and methods of assigning authority and responsibility; and
- mechanisms of imposing control, including the internal audit and review functions, management actions, assurance and compliance arrangements and organisational policies and procedures.

It is the responsibility of management to establish and foster a control environment which is economic, efficient and effective and which ensures that

- activities are conducted efficiently and in compliance with the organisation's objectives, policies, plans and procedures;
- assets are safeguarded and properly accounted for;
- there is reliability and integrity of financial and operational databases and controls;
- there is a provision of relevant and reliable corporate and operational management information to support tactical and strategic decision-making; and
- there is compliance with legislation, regulations, directive and directions.

Control procedures are policies and procedures complementing the control environment and that are established to achieve specific objectives.¹³ They include, in particular, procedures and processes designed to prevent or to detect and correct control weaknesses, to address compliance gaps and to prevent, detect and correct errors. The primary responsibility for managing risks lies with line management. Internal audit's involvement should stop short of responsibility and accountability for risk management across the organisation and of managing risks on management's behalf. However, in order to add value, it is often beneficial for internal audit to give proactive advice or to coach management on embedding risk management

¹²Leitch (2008).

¹³American Institute of Certified Public Accountants, Internal Control over Financial Reporting, 2006.

processes into business activities. Internal audit has a vital role in challenging established risk management processes, in challenging risk identification and, more fundamentally, in providing assurance to officers and members on the effectiveness of controls. However, this is separate from the activity of establishing and operating risk management processes and control structure, which is the responsibility of management.

6 Conclusion

This chapter has examined a number of key areas that NGOs, large and small, should be aware of from a financial management perspective. In seeking donor funding, NGOs have to ensure that the project budget is intrinsic to the project plan, which means that the budget is realistic and directly relates to project activities, outputs and objectives. The chapter has also highlighted that, from a donor-funding perspective, it is crucial that NGOs effectively manage their budgets through proper and efficient budgetary control systems. The second part illustrated the importance for NGOs to produce financial reports. Some of the key reports that are statutorily required for NGOs include their annual financial statements. These are reports of the income and expenditure, assets and liabilities, and capital and reserves of an NGO for a particular period. They are normally audited by an external auditing firm and are used by many stakeholders. The third section of this chapter dealt with the need to assess the financial capacity of local partners. This is particularly important for international NGOs, which are required, from a donor-funding and capacity-building perspective, to involve local partners in their projects. The chapter presented a basic financial health checklist that may be used in assessing the financial capacity of local NGOs. The final part of this chapter looked at the area of governance and control. In particular, it examined the relationship between corporate governance, risk management and internal controls. This relationship is of paramount importance for NGOs in the management, transparency, accountability and stewardship of donor funds.

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