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MANAGING FINANCES
AND RELATED SYSTEMS

by Natalie Merlini Gaul

CHAPTER 7 OF *HEALTH SYSTEMS IN ACTION*

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CHAPTER 7

Managing Finances and Related Systems

Natalie Merlini Gaul

In this chapter, we examine aspects of financial management and related office operations systems. Financial management is concerned with accounting and budgeting, along with reporting and analysis, that allow managers, donors, and overseeing bodies not only to know about revenue obtained or generated, assets owned, and expenses incurred but also to compare that information to previous years or desired results.

Operations management focuses on systems that support the organization in reaching its objectives. These systems include procurement (also known as purchasing), travel management, inventory management, and personnel management systems such as payroll and benefits. These systems are closely linked to financial management because they have a direct bearing on how funds are spent and reported, how the organization's assets are monitored and safeguarded, and how employees are compensated.

Chapter 6 of this handbook covers the policies, systems, and leadership and management practices that together make up human resource management (HRM). Information systems are presented in Chapter 9.

As a manager of a health program or health services, you can use information in this chapter to guide you in establishing internal controls as a framework for all financial management activities. Internal control mechanisms provide a basis for making sure that the use of an organization's precious resources is appropriate and that the resources serve the organization's mission, maximize impact, comply with laws and donor regulations, and meet established standards for ethical conduct and sound operational practices.

You will also find both tools and links to help you assess the status of your organization's financial and operations management, and suggestions to strengthen any weaknesses you might find.

The breadth of topics and the array of basic information in this chapter and its appendixes make it the longest in this handbook. If you do not directly manage or oversee an area related to financial management and operations, you can selectively familiarize yourself with how these critical functions affect your organization's ability to meet its strategic objectives and also learn how you can support sound financial management.

Introduction

Increasing global awareness of the serious health problems faced by developing countries has resulted in a widespread desire to address these issues. This requires strengthening the ability of governments and civil society organizations (CSOs)—faith-based, community-based, and nongovernmental organizations (NGOs)—to manage health projects and service delivery programs effectively and efficiently. To fulfill their growing responsibilities, both public- and private-sector entities must manage funds with the utmost care and integrity. They share similar needs for efficiency, effectiveness, and transparent use of financial and other resources.

Shifts in donor priorities or the economic climate may reduce the amount of funding available to support health programs. Economic factors may raise the costs of required goods, labor, and services. To cope with these scenarios, public health managers at all levels must understand and implement sound accounting and financial management principles to safeguard their scarce resources and respond to changing economic conditions.

In addition to efficient and effective operations, financial management, and accounting systems, organizations must have strong internal control mechanisms to guard against misappropriation or fraud. Well-documented policies and procedures will both support the workforce and demonstrate fiduciary responsibility and stewardship to funders.

Organizations that demonstrate these high standards have the best chance of securing and maintaining donor funds and protecting their own working capital.

The leadership and management practices shown in the Leading and Managing Framework in Chapter 2 of this handbook all apply to financial management.

You and the leaders of your organization, including its board of directors, must **scan** for risks that might impact the financial health of the organization as well as for opportunities to generate support and funding for the organization's mission. Scanning will also uncover best practices related to financial management as well as constraints that may affect the organization.

As a manager who leads, you should **focus** financial management actions so they reflect the organization's mission. You must determine priorities related to generating funding, investing in staff or equipment, or managing expenses to achieve the strategic objectives of the organization.

You need to **align** your organization's financial goals and expectations, operations systems, and practices with its mission and vision. You must also **mobilize** resources, including capable staff, so that finance and operations systems operate optimally.

A critical, but sometimes overlooked, role of leaders with regard to financial management is **inspiring** staff to comply with policies and procedures related to financial dealings, use resources wisely, and avoid conflicts of interest and unethical behavior related to financial transactions.

To serve as a role model, you should demonstrate honesty and integrity in the use of the organization's resources. You must also demonstrate understanding of and respect for prudent fiscal behavior and the related internal controls. Your deeds and example will speak louder than your words.

The organization's activity, finance, and administrative managers engage in the four management practices with regard to financial management.

You and other managers carry out a variety of **planning** activities, such as drafting operating budgets for the current year and projections for future years based on the organization's strategic plans. You develop purchasing plans for needed equipment and other capital assets. And you develop plans to prevent or respond to potential risks that might impact the financial health of the organization.

Managers **organize** systems, structures, work processes, and policies. They recruit and train staff to ensure that efficient, transparent, and appropriate financial and administrative actions are executed.

Finance managers **implement** the established policies and practices. Managers across the organization must use financial information to make decisions about activities and adjust plans as circumstances or available resources change.

Finance and general managers must **monitor** the financial activities of the organization, **evaluate** the results, and identify needed changes to work processes and procedures, budgets, or planned uses of resources.

Financial management focuses on controlling, accounting for, conserving, and investing an organization's resources (cash, employees, inventory, equipment, and time) to meet planned objectives.

There is a perception that financial management is a narrow discipline, similar to compensation management or the management of medicines and health products, or that only accountants and bookkeepers need to understand financial information. For those who lack formal financial training, the unique vocabulary and rules of financial management are sometimes regarded as too complex, dull, or even intimidating.

However, all managers—even those not directly connected with the accounting functions—benefit greatly from having a basic knowledge of the principles and tools of financial management. Managers at all levels of an organization must concern themselves with financial matters or they will soon find that they do not have the resources they need to accomplish long-term goals or maintain day-to-day operations.

Financial management skills include:

- **accounting** for financial transactions;
- **planning** for operational activities, equipment purchases, and uses of labor;
- **costing** and **pricing** of goods and services;
- **forecasting** revenues and future expenses (sources and uses of funds);
- **monitoring** and **controlling** the use of resources.

Financial management uses these skills to maximize the use of assets, control costs, and plan activities to have the greatest impact and achieve desired goals.

Two Financial Truths

1. Assets, including time, are always limited.
2. Organizational objectives and needs are ever changing and seemingly unlimited.

In this chapter, we cover the following topics:

Depending on your interests, time, and the needs of your organization, you may wish to focus on specific sections and their related resources. You can read these sections, with the exception of the overview, in any order or selectively.

Overview of financial management and operations management

Financial management and related operations management play a vital role in your organization's achievement of its goals. It is not uncommon for conflicts to arise between the finance, operations, and administrative components of the organization and the technical or program staff who are designing and implementing health programs or providing services to clients.

Perhaps you have heard statements such as:

- Finance and operations staff, with all their rules and regulations, cause too many delays and bottlenecks!
- Finance and operations staff don't understand the needs or challenges of the service delivery teams!

In reality, all program, operations, and finance staff have roles and responsibilities related to managing risks and producing results for the organization. Tension among different functions is generally healthy and often unavoidable. When staff understand and respect each other's roles and can evaluate conflicting needs in a broad context, the degree of tension will be minimized.

All staff should understand that finance staff must ensure that resources are available and that the organization maintains its economic health and conducts its affairs in a transparent manner. It must be accountable to its clients and donors and must act in accordance with rules of law, international standards for sound business practices, and ethical behavior. This is the finance staff's contribution to fulfillment of the organization's mission.

By sharing analysis of past financial results and trends, your financial staff can influence programmatic decisions, such as:

- pricing or cost recovery schemes for services;
- determining whether to expand or eliminate programs;
- improving work processes and increasing technological capacity, staff levels, or compensation;
- expanding fund-raising or capital generation to meet projected shortfalls that will prevent the achievement of short- or long-range goals.

If the programmatic, technical, and operational elements of your organization are well integrated at all stages of planning and implementation, conflicts will be minimized or eliminated. Include the finance and operations manager(s) in annual and strategic planning from the start so they are not simply creating budgets for plans that were developed without their input. And you should instill an understanding in all staff of financial constraints, sound organizational practices, and ethical behavior with relation to how the organization's assets are used. The ideal is an ongoing, two-way loop of communication and engagement that draws upon the expertise of—and considers the needs of—all functions.

You can help your colleagues understand how the finance function contributes to the success of their programs by documenting and distributing policies and procedures, as defined in Box 1, throughout your organization; by training staff in the application of these policies and procedures; and by communicating how all staff are expected to comply with and enforce financial management policies.

When thinking about financial management, it is easy to become narrowly focused on choices related to accounting activities, such as:

- how to organize financial reports and budgets;
- how to track and consolidate financial transactions;

BOX 1. Definitions of Policies and Procedures

What Is a Policy? A policy is a managerial directive pertaining to accepted business strategies, objectives, and standards. It answers the question: what will be done?

How Are Policies Determined? Boards of directors and senior managers generally set policies that reflect the mission, strategic objectives, and standards of the organization. An organization may also need to adopt or adapt policies to comply with rules and regulations established by donors and governments. Policies should reflect the values of the founders, owners, directors, staff, and volunteers of the organization.

What Is a Procedure? A procedure is a methodology or series of actions that is followed to carry out a policy. It answers the question: how will it be done?

- whether to keep detailed accounts or summaries by broad account categories;
- which software to use to capture financial transactions;
- whether to pool costs by department, project, and program objectives or by organizational level;
- the most efficient and cost-effective way to staff and organize the financial management function.

If your interest in financial management within the organization is limited to accounting activities, it is focused on the past, rather than the present and future, because accounting is generally the recording and reporting of financial transactions that have already occurred. It results in the financial reports needed to satisfy tax requirements, convince a bank or donor to provide funding, or equip a manager with historical data needed to create projections and budgets for future activities.

But broadening the financial management perspective to include procurement, travel and logistics, and facilities management moves the focus to the present and future. The emphasis is no longer only on recording what has already happened; the emphasis is also on influencing how funds will be expended now and in the future.

The benefits of integrating financial management and operations management include:

- ensuring that assets already obtained will be kept safe, in good working order, and available for the use of programs that require them;
- deciding what will be bought and how, so that the best value is obtained;
- allowing for enhanced revenue generation through proper pricing of goods and services that is acceptable to clients;
- safeguarding the organization and the individuals involved in its ownership, management, or program implementation by ensuring that financial transactions are conducted lawfully and ethically;
- creating an organization that fairly compensates staff for their work while at the same time allowing for the provision of quality services that serve the broadest possible client base.

A word of caution. The materials in this chapter are of a general nature and represent best practices that should be relevant worldwide. It is not possible, however, to address all the country-specific situations that could have an impact on your individual organization.

This chapter is intended to inform you as a manager of a health program or health services and enhance your ability to manage program activities by understanding the role of finance and operations. This understanding should be combined with:

- recruitment of financial managers and operations managers who have the relevant education and work experience;
- active involvement of finance and operations managers in program management activities, especially planning;
- engagement of public or chartered accounting firms or audit firms to routinely review your financial statements and internal control systems;
- seeking advice from lawyers or tax accountants who understand the country context, applicable laws, and requirements for an organization of your type. Professional advice can prevent major issues, including fines or lawsuits resulting from noncompliance with laws and regulations.

Assessing your organization's financial and operations systems

An assessment of the current financial health of an organization and its prospects for the future should include a review of:

- the financial and operations systems, structures, policies, procedures, and practices;
- the organization's capacity to provide services;
- the availability of capital from donors or the government or revenue generated from the sales of services and commodities.

Depending on the size and staffing of your organization, you may want to hire a consultant to help conduct the assessment, analyze the results, and implement needed changes.

Three tools—QuickStart, the Financial Management Assessment Tool, and the Management and Organizational Sustainability Tool (MOST)—can help your organization check its financial management systems.

- QuickStart is a relatively simple assessment tool that is most appropriate for small, fledgling organizations or organizations interested in obtaining a quick snapshot of their capabilities and weaknesses in accounting, financial management, and operations systems. The answer key serves as a basis for staff development and systems strengthening.
- MOST takes an in-depth view of the organization's overall management, including financial management, and is better suited to slightly more mature organizations.
- The Financial Management Assessment Tool provides a detailed look at the financial management systems of an organization and is best suited to large, complex organizations.

Your organization might decide that strengthening financial management systems will require major capital outlays for initiatives such as the installation of a sophisticated accounting software package; recruitment of additional accounting, administrative, and support staff; or expansion of fund-raising activities to generate additional funding or win new contracts.

However, most organizations find that relatively small improvements, at low or no cost, are all that is needed to reap significant benefits. Such improvements generally involve strengthening internal control systems, documenting financial policies and procedures and communicating them to staff, and instilling in all staff members an understanding of how they contribute to maintaining the financial health of the organization.

In the past decade, the cost of computer equipment has decreased significantly, and access is far greater. Many accounting software packages geared toward small organizations are commercially available and require little modification to be applicable to nonprofit organizations.

Staff members are increasingly likely to have computer skills, including the ability to use spreadsheets and databases, which greatly increase their capacity to do financial analysis, use forms and templates, and generate reports. Many large organizations provide staff with Internet access, and some have internal websites that are a major resource for performance improvement and the sharing of financial information.

Not only will improvements in finance and operations systems strengthen the health of the organization, sound management practices will also make a good impression on potential contributors. They will be more inclined to award projects or make donations because they have confidence that the funds will be used appropriately, desired results can be achieved, and the results will be accurately documented and shared.

Accounting and financial management basics

Valuable lessons learned from history help us prepare better for the future. Financial data provide a powerful history lesson that allows managers to better budget for future costs, project cash needs, and forecast growth for their organization. These lessons are often communicated by the organization's financial management staff through their routine reporting and financial analysis.

WHAT IS ACCOUNTING?

The section below outlines accounting methods, basic principles, and reports. If you have experience in financial management, you may wish to skip this section. If you are unfamiliar with accounting terminology, consult the Glossary in this chapter for definitions.

Accounting is a system of consistently recording financial transactions. In the simplest terms, the goal of accounting is to document what an organization owns, its debtors (those who owe it money) and creditors (those to whom the organization owes money), income, and donations. Analysis of accounting data helps determine whether revenue or funding is sufficient to cover costs and allow for growth. It is a mix of art and science.

The science comes from the application of rules and standards. Accounting standards are dictated by national governments, tax authorities, and the international community of accounting professionals. Standards focus on the ethical and appropriate use of resources and how financial transactions are reported. These standards attempt to ensure that similar transactions are treated consistently and that revenue is linked with the expenses incurred to generate it.

The concept of linking revenue to related expenses is known as the matching principle. This makes it possible to compare results from year to year, and to some degree, among organizations. Financial information must be gathered completely and accurately to guarantee the reliability of financial statements.

Accounting standards provide guidelines on how the principal financial reports use measurements and are organized, recorded, and reported. These standards are documented in a publication called the *Generally Accepted Accounting Principles* (GAAP). The standards of the United States and the United Kingdom are used throughout the world, but other standards exist to meet unique conditions found in other countries.

The art of accounting is evident when financial reports are created in a way that tells a story and provides sufficient information for administrators and technical activity managers to make sound operational decisions. A well-designed chart of accounts (see Box 2) that determines how information is categorized and summarized is key to the ability to create analytical reports that easily allow managers to interpret financial results.

For more information, see "Sources of data for reporting" in this chapter.

BOX 2. The Chart of Accounts

The chart of accounts is a list of the categories of financial transactions that will be tracked in the accounting system and flow to various financial reports. To make data entry and tracking easier, these account types are generally assigned an identification number.

Although the chart of accounts varies among organizations, there are some generally accepted standard categories:

- **Assets:** what is owned, including cash, investments, equipment, furniture, or what is due from others, such as clients or donors;
- **Liabilities:** short- and long-term debt that is owed to vendors, banks, staff, or government agencies;
- **Equity:** cash, property, inventory, and equipment that belong to owners, partners, or shareholders after deducting liabilities from the organization's assets;
- **Income:** revenue generated through operations, sales, donations, and fees for services;
- **Expenses:** costs for materials, supplies, travel, wages, services, facilities, medicines, commodities, etc. This is often the lengthiest section because a detailed list of such costs is useful for financial management, reporting, and budget monitoring.

Accounting that is executed in accordance with all the rules does not necessarily guarantee useful management information. Reports must be clear enough to be interpreted accurately, and they must reach the people who have the power to make operational decisions. Needed reports must also be timely to allow managers enough time to take corrective action, if necessary. All too often, financial reports are designed only to satisfy governments or donors at the expense of meeting the needs of the organization. Although satisfying these requirements is essential to receiving future funding, it may be necessary to negotiate report formats or prepare multiple financial reports to satisfy both sets of needs.

If you understand how to interpret financial statements and analyze results, you are less likely to make poor decisions or jump to false conclusions. It is especially important to understand if the reports disclose all costs, including indirect ones.

The accuracy of financial data is paramount, but the statements must also tell a true story by reporting the right (relevant) data, as soon as possible after the transactions occurred (timely), and in a clear (simple) format. Financial statements should illustrate, rather than obscure, the fiscal position of the organization.

In other chapters we review SMART criteria for defining objectives. Here's a memory tool for keeping the SMART in financial reports:

S = Simple
M = Meaningful
A = Accurate
R = Relevant
T = Timely

STANDARD ACCOUNTING REPORTS

As a manager, you probably receive several standard accounting reports designed to help you determine the financial health of your organization. Some managers make a major mistake by not reading them. If your organization uses computerized accounting software, key reports should reach you early enough to help you make important adjustments in activities and programs when actual results are not in line with budget expectations.

Accountants report on historical financial events and performance using two primary reporting tools: the balance sheet and the income statement. These reports reflect the health of an organization at a specific point in time. They are generated quarterly or monthly.

The more frequent and current the reports, the greater the possibility that you can make decisions while there is adequate time to influence future financial results. Most organizations will want—and may be required—to have these reports prepared or reviewed annually by an outside accounting or audit firm.

The balance sheet. The balance sheet focuses on the assets, liabilities, and equity of an organization. (See Appendix A for an example.) It is a snapshot of account balances at a specific time. The fundamental principle of accounting is that assets equal liabilities plus equity. The standard format of a balance sheet contains two schedules. One schedule reports on the value of the assets of the organization. The second schedule details the liabilities and the equity of the organization. The total of the first schedule will equal the total of the second schedule. This is the concept of balanced books—the two schedules must offset one another to show the overall value of the organization.

The balance sheet can take a variety of formats, depending on the level of detail desired, but will always include:

- the total value of assets on the date specified;
- the total value of liabilities on the date specified;
- the total value of equity on the date specified.

The income statement. The income statement (also known as a profit and loss statement) reports on income and expenses resulting from the organization's operations. (See Appendix B for an example.) The format lists all sources of income first, followed by expenses. The end of the report is an expression of income minus expenses that determines what is often referred to as the bottom line. A positive result indicates a profit from operations; a negative result indicates a loss.

Income statements are often categorized by departments, divisions, or geographic location. This makes it easier to determine which departments or service areas are covering costs, generating profit, or running at a deficit. Nonprofit entities may not prepare income statements, but they will need to prepare similar reports on the sources and uses of funds. Regardless of their status, however, all organizations must be concerned with covering the full costs of operations and generating funds for future expansion and growth.

Two other key financial management tools that focus on the future are budgets and cash flow statements.

Budgets. Budgets are expressions of expected future income and expenses. They are generally based on historical data, if available, and adjusted based on assumptions regarding inflation, increases or decreases in income or expenses, and expected expansion of programs and services. Once created, budgets become a tool to monitor current operating performance: Are costs higher than planned for? Are sales or services less than expected? Is funding less than expected?

Reviewing budget results and reacting quickly allows you to take corrective action before too much money or other resources are lost, or to use unanticipated resources to capitalize on opportunities that have arisen.

If there are variances between budgets (planned) and results (actual), it is important to analyze the reasons. You can begin by looking at the big picture:

- Did we do what we planned to do?
- Did it cost what we expected?
- Has our income or funding been at the planned levels?

There are further questions you can ask to determine the causes of budget variances:

- Is there an error in the budget values or the financial results due to a clerical error or miscoding?
- Were the budget assumptions inaccurate or incomplete?
- Is the variance related to timing of income or expenses that will self-correct in the next accounting period?
- Has the market changed, resulting in higher or lower costs or more or less demand for services or commodities?
- Were the historical data incomplete, inaccurate, or misinterpreted, leading to flawed budget amounts?
- Are the variances an indication of poor performance, misuse of funds, or changes beyond the control of the staff of the organizations?

Once you have analyzed the reasons for the variances, you can respond to them by asking four key questions:

1. Do you need to adjust the budgets and, as a result, expectations about future spending or income levels?
2. Is it necessary to cut activities or reduce costs?
3. If budget variances are positive, is it possible to increase activities or invest in long-term assets?
4. Should you do nothing, expecting that the variance will self-correct? If you choose to do nothing, it must be a deliberate decision and not the result of ignoring the financial data.

The answers to these questions will help you create better budgets in the future, as well as provide insights into market trends or inefficiencies within your organization.

Cash flow statements. Cash flow statements detail cash coming into the organization from donors, customers, and investment income as well as cash spent for general and administrative costs, program expense, or investments. Cash flow statements are concerned only with cash position, so factors such as accounts receivable and accounts payable that have not yet impacted cash are not considered. These statements help managers predict needs for cash and plan the timing of income and expenditures. These projections are critical because an organization can find itself in trouble if cash is not available when expenses are incurred. Ideally, cash flow in will be greater than cash flow out.

SOURCES OF DATA FOR REPORTING

The backbone of financial reports is the chart of accounts and the general ledger.

The chart of accounts. This is a listing of code numbers and descriptions that itemize the types of income, expenses, assets, and liabilities about which information will be accumulated, tracked, and reported. The chart of accounts should reflect a balance between what the accountant needs to satisfy statutory requirements and standard accounting practice and what program managers need to plan and monitor. It should be detailed enough to give you sufficient data to make decisions and plan for relevant categories or types of expenses. However, the account codes should not be so numerous or complex that coding, recording, sorting, and reporting on financial transactions become labor intensive or costly.

Often the creation of the chart of accounts is left to the accountant. It is essential, nevertheless, that managers in the organization are clear about the types of information and reports they need, so that a useful chart of accounts can be created and maintained.

For example, it is difficult to provide monthly data on the cost of gasoline if the costs of water, oil, electricity, and gasoline are all summarized under Utilities. The use of computers to process financial information has increased the ability to expand coding and reporting possibilities without greatly increasing costs or labor.

The general ledger. This is the primary financial record of an organization. All financial transactions are recorded in it, either in detail or summarized from other subsidiary journals or ledgers that track items such as revenue, expenses, and labor costs. Transactions are recorded in an orderly fashion, by date, and in accordance with the chart of accounts.

Sometimes the general ledger is a very large book, completed in pen and ink, but today it is more often a data file and a series of computer-generated reports.

As a manager, you will be most efficient if you can link an expense with the activity, service, or department that generated it, so that you can analyze the cost in relation to the benefit received. Many managers recognize the need for integrated systems in which financial information interacts meaningfully with operational and program data, and accounting information is linked to budgets.

New technology such as computer disks that can store vast amounts of data, readily available and user-friendly accounting software, and lower costs for high-speed computers are making it easier for managers to satisfy their need for integrated information.

DEBITS AND CREDITS

Accounting has a unique vocabulary. Assets, liability, equity, income, and expenses have already been mentioned. Debit and credit are two other important terms that originated in the earliest days of double-entry bookkeeping. Whether accounts are kept in paper ledgers or in computerized files, debits are treated as positive numbers and credits as negative numbers. In keeping with the principle of balanced books, the net result of the debits and the credits must be zero.

Debits. A debit is a positive number, recorded in the left-hand column of a manual ledger. It is used to record increases in assets or expenses and decreases to liabilities and equity. This statement might appear counterintuitive, but it is the generally accepted accounting protocol. This principle can be memorized.

Credits. Credits, posted in the right-hand column of a manual ledger, are negative numbers and are used to record increases to liabilities, equity, or income and decreases to assets and expenses. For each financial transaction, there are offsetting entries of debits and credits. The net effect is a balanced transaction totaling zero. See Box 3 for an example.

It should be noted that in a computerized accounting system the user may not always see columns or the placement of the debits and credits because the software will assign the

BOX 3. A Debit and Credit Example

You wish to purchase an order of paper for the printer that costs $1,000. This will be recorded to an expense account called Office Supplies. This transaction requires the use of funds being held in a checking account, which are tracked as an asset.

The office supplies account is increased by $1,000 (the debit entry, or positive number).

The checking account is decreased by $1,000 (the credit entry, or negative number).

$1,000 – $1,000 = 0, indicating that the books are in balance.

Cash Account	Expense Account	Net
Checking – $1,000 (credit entry)	Office Supplies + $1,000 (debit entry)	0 (balanced books)

proper status based on the nature of the transaction being posted. However, it is important to understand this principle because some entries, such as general journal entries or adjusting entries will normally require the accountant to manually indicate the debit and the credit sides of the entry.

ACCOUNTING METHODOLOGIES

This section discusses three accounting methodologies: **cash basis accounting**, **accrual basis accounting**, and **activity-based cost accounting**.

Cash basis accounting. Cash basis accounting is relatively unsophisticated. Revenue is recorded when it is received, and expenses are reported when they are paid. The focus is solely on when cash enters or leaves the organization and not on when the revenue was actually earned or when the expense was actually owed or incurred. This method of accounting can seriously misrepresent the present financial position of an organization.

For example, if an organization elected to prepay the next year's rent and purchase all the supplies needed for the upcoming year in December, the bottom line at the end of December might reflect expenses far exceeding income. It would not show that these expenses purchased assets and inventory that will be used at a later date.

Similarly, if expenses have been incurred, but payment for them has not been made, financial results will seem more positive than they actually are. With this accounting methodology, it would be possible to manipulate financial results to appear more profitable or to reduce income tax liabilities by timing the payment of debts.

Accrual basis accounting. To present a more accurate financial position, an organization can use accrual basis accounting. In this methodology, revenue is recorded when it is earned and expenses are recorded when they are incurred, without regard to when the cash changes hands.

Two special balance sheet accounts, **accounts receivable** and **accounts payable**, are used to recognize income and expenses as they are incurred. They are cleared when the payment is actually received or a vendor invoice is actually paid. This leads to a more accurate profit and loss statement that is free of the misrepresentations possible in the cash-based method.

Returning to the previous example, in an accrual-based system, the prepaid rent or supplies would be recorded as assets in December, with no effect on the expense accounts until the rent is owed and the inventory used. Each month in the following year, you would make entries to reduce the prepaid accounts and recognize the actual expenses.

You can account for the usage of assets, such as buildings, vehicles, or equipment, by recording depreciation, which distributes the cost of the asset over its useful life. For example, only one-fifth of the cost of a truck, expected to be in service for five years, would be charged as an expense each year. Similarly, the cost of major expenditures, such as research and development, are often amortized—spread out—over a period of time.

Activity-based cost accounting. Activity-based cost accounting attempts to calculate the full cost of an activity, project, or service through the allocation and attribution of support costs. For example, the cost of providing a medical exam includes not only the doctor or nurse's time and supplies used during the exam, but also some portion of the clinic rent for an exam room, use of equipment, and even a small portion of the salary for a clinic manager, receptionist, and accountant.

The goal of activity-based cost accounting is to track and disclose the total costs of all technical activities, including a fair proportion of the indirect costs incurred in execution of these activities. There are two major reasons for you to use activity-based cost accounting:

1. If an organization is self-sustaining, it is critical for you to understand the full cost of activities because this allows you to make well-informed decisions about pricing, cost recovery, and service mix.
2. In a multidonor environment, using this type of accounting allows you to charge donors only for the costs they have agreed to support.

TYPES OF COSTS

There are two general types of costs that are incurred within your organization: direct costs and indirect costs.

Direct costs are incurred exclusively for a given project or program activity. For example, an organization might purchase and distribute condoms as part of a family planning project. The cost of the condoms would be a direct cost to that project because there is a direct link to that, and only that, activity.

There are two basic categories of indirect costs: (1) general and administrative costs that cannot be assigned to any particular activity, and (2) indirect costs related to programmatic activities but not exclusively to a single project or program.

General and administrative (G&A) costs. G&A costs, also called overhead, are expended for the benefit of the entire organization. They are essential for the execution of the technical work but cannot be assigned directly to a particular project or activity. Examples are:

- real property: literally, the roof overhead, including rent and utilities;
- labor: salaries for administrative, accounting, maintenance, and general management staff who provide support to all projects;
- general office supplies, such as paper, computer supplies, and cleaning supplies, if shared by all;
- shared office equipment, repairs, and services such as photocopying, postage, telephone, and Internet access.

The indirect costs of technical activities, including related management. These are costs incurred specifically for the benefit of programmatic activities, but that are shared among several projects or activities. These can include salaries, supplies, equipment or other costs that are expended solely for the benefit of specific program activities.

Donors often restrict the amount of funding that can be applied to overhead costs by setting limits on the overhead rates in project budgets; they prefer that the funds be used for activities in the project or program they are sponsoring rather than for general organizational support. With this understanding, your organization may be able to legitimately shift some traditionally indirect costs to direct costs if you have the technology to minimize the accounting burden.

For example, photocopiers and telephone systems can often be modified to require charge codes that make it possible to analyze bills by activity code. Usage logs can also be maintained by hand for these types of charges. However, the discipline required to maintain such logs consistently, as well as the effort required to analyze and tabulate the logs each month, might not be worth the benefit derived from allocating these costs directly.

The methods used and systems required to attribute costs directly to projects should not be so time-consuming, costly, or onerous that the burden outweighs the benefits.

Indirect costs can be further defined as either **allocable costs** or **attributable costs.** They are treated separately in Appendix C. Appendix D shows how to calculate an indirect cost rate.

When costs benefiting multiple activities are to be apportioned among those activities, the rationale for distributing those costs should reasonably reflect the benefit. For example, if an organization wanted to allocate the cost of an Internet connection and email server, it could use a percentage based on the number of staff working on a particular activity. An activity with more staff would bear a larger share of the cost of the Internet services.

IMPLEMENTING ACTIVITY-BASED COST ACCOUNTING

First, your organization must determine how it will define its activities (see Box 4) and at what level of detail. This fundamental decision affects the type of accounting system required and might lead to a decision about how records are organized, whether records are compiled manually, or whether new software is needed. Information about selecting

BOX 4. Defining Activities

What your organization defines as an activity (or project or subproject) is often based on in what form donors or boards require financial reports or how program staff members manage and monitor operational plans and budgets.

The definitions of activities, projects, or subprojects depend on:

- the source of funds, such as a donor agreement or contract;
- health outcome areas, such as family planning, infectious disease, or child survival;
- geographic regions;
- program interventions, such as service delivery, training, or behavior change communication;
- operating departments.

accounting software appears in Appendix E, and Appendix F provides tips about implementing new software.

Implementation of an activity-based cost accounting system requires that the costs be assigned to the applicable activity *at the time it is incurred*. This requires an accounting system that can track and report costs in this manner by using such processes as:

- timesheets on which staff indicate the amount of time they spend supporting each coded activity;
- purchase orders or procurement requests that indicate which activity a particular good or service is for;
- the assignment of travel costs (including use of the organization's vehicles), to the activity that incurs the transportation, lodging, meals, or other costs related to travel.

All staff, not just the accounting staff, must use these processes because only the originator of the cost may know which activity the cost is supporting. There may be some resistance to using the new processes and forms if your organization has not already established this system. Because management systems depend on people, communicating to your staff the rationale behind the changes will encourage them to cooperate. You can apply the principles of leading and managing through change described in this handbook, most notably in Chapter 2, as you make the transition.

EFFICIENT USE OF RESOURCES

Anyone in an organization who has control over the use or purchase of resources is a financial manager. This role is not limited to the accounting staff or managers who approve budgets or sign checks. To varying degrees, *all* staff members act as stewards and custodians of assets on behalf of donors, sponsors, owners, and especially the clients being served.

If you have the ability to incur a cost, use an asset, develop or approve a budget, or obligate the organization financially, you must occasionally wear the hat of a financial manager. Any decision you make that affects the use of the organization's resources impacts its ability to provide the desired quality and quantity of health care services.

BOX 5. Three Powerful Money-Saving Practices for Financial Managers

Substitution. If your review of the budget or financial statements reveals a shortfall, you may be able to substitute lower-cost inputs: labor, supplies, outsourced services, or modes of travel, for example. Looking for new suppliers who offer lower prices, or flying in economy class rather than business class are examples.

Economies of scale. You may be able to negotiate better prices for needed goods and services by purchasing in larger quantities or establishing long-term contracts with vendors. This can be a wise approach if there is adequate cash or credit available for the purchases and if stockpiled supplies can be protected from loss, theft, and spoilage.

It is important to balance the savings of buying in bulk with the cost of possible spoilage and the cash drain of having too much money tied up in idle inventory rather than being available for immediate needs.

Reduction of idle capacity. If staff or facilities are not fully used, you may be able to assign them additional functions or loan or rent them to others. For example, empty offices might be leased to another organization or a secretary with free time during the day might be trained to take on some accounting duties. These staff or facilities represent sunk (fixed) costs. Although the total costs of these resources will not change, the outputs from those costs can increase or additional funds can be generated to offset some of them.

Therefore, it's important to be able to recognize a **financial obligation**, which can be defined as an agreement to hand over an organization's assets, generally cash, in exchange for goods, services, or other assets. You commit to such an obligation when you issue a purchase order, sign a rental agreement or lease, award a contract to a consultant or vendor, or make an employment offer to a staff member on behalf of your organization.

As a manager, you must continuously seek the most efficient uses of limited resources to achieve the goals and strategic plans of your organization. The environment is constantly changing because of factors such as new technology, demands in the marketplace, availability of scarce resources, and political situations.

Financial management requires you to use management and leadership practices such as scanning the environment and monitoring changes to look for opportunities to change operational practices or alter plans so that your organization can take advantage of—or counteract—these changes.

Examples of the steps managers can use to address shortfalls and variances from plans include:

- **cutting costs** by taking measures such as reducing staff or changing operating hours;
- **raising prices** for services or commodities;
- **marketing** to increase sales;
- **changing service or product mixes** to eliminate less profitable elements;
- **changing the timing of activities or expansion** to better meet the timing of revenue;
- **creating a staffing structure** that establishes segregation of duties;

- **implementing policies of internal control** that safeguard against theft, fraud, misuse, or loss of resources;
- **hiring competent accounting staff and external auditors** as well as orienting general managers to their role in the financial management and health of the organization.

Box 5 shows other ways of making the most of scarce resources.

As a manager you have to keep in mind the ultimate goal: providing quality services at a price that clients can pay or that can be supported through other funding sources. Depending on circumstances, your ability to influence the situation might be limited. Donors often specify how donated funds can be used and require reporting as a condition of their donation. Donors may set approved budget limits and cost ceilings.

Donated funds may also come with cost principles outlining what types of costs are allowable or unallowable, such as prohibitions on the use of funds for entertainment or alcohol.

Managing risk

Finance managers are often given the task of managing risk for the organization. Although some risks are programmatic, many fall into the realm of financial management.

Risks have three common elements: a negative event or practice, the probability of occurrence, and the severity of occurrence. Costs or losses can be monetary or intangible, such as the tarnishing of the organization's reputation or a decline in clients' confidence or a donor's trust.

SOME RISKS RELATED TO FINANCIAL MANAGEMENT

Financial managers must contend with and manage numerous risks, such as:

- lack of information about the true costs of providing products or services;
- assuming you can make it up in volume without recognizing that if you are generating losses, volume only creates larger losses;
- dependency on donors or a limited number of donors;
- setting prices for services too low;
- failure to monitor the changing environment;
- condoning poor budgeting, planning, and reporting practices;
- failure to take advantage of opportunities;
- failure to cover overhead costs.

Strategies for dealing with risk include acceptance, avoidance, and control. You can accept the risk and take the loss, avoid the risk, or control it through mitigation and contingency.

Risk: The potential for occurrence of an event with negative consequences.

Risk = the cost of a negative event × the probability of the event happening.

Mitigation. Mitigation is a before-the-fact technique. It requires analyzing what could happen, the probability that it will happen, and how damaging the results would be. The aim is to put policies and procedures in place to monitor any events or circumstances that might trigger risk events and to prevent them, control them, or lessen their severity. Analysis of financial data is one way to monitor risk and quantify results.

Contingency. Contingency is an after-the-fact technique. It involves having plans in place that can be quickly mobilized if the unfortunate event occurs. By carefully identifying possible risks, you may be able to identify possible solutions. Contingency provides a "cure" for the consequences after a negative event has occurred. It is wise to build schedule and budget reserves into project plans to cover risks that cannot be mitigated.

Guidelines for preparing a risk management plan appear in Appendix G.

DOCUMENTATION OF FINANCIAL TRANSACTIONS AND AUDIT TRAILS

All financial transactions must be thoroughly documented, from the initial approval to final payment. This includes approved purchase orders, shipping receipts, and dated and itemized vendor invoices. All transactions must be traceable to the financial reports and bank records. This is generally done by assigning a unique transaction number to each financial transaction that flows from the source documentation to the accounting system and subsequent reports.

All transactions should show prior approval by the appropriate, authorized director or activity manager. Prior approval is an essential element of financial control. If approval is not in place until after the transaction has occurred and the check is being signed, it is too late to prevent an unallowable use or misuse of funds. Box 6 offers ways to be certain that approval is warranted.

The documentation should make the purpose of the expenditure and, when applicable, the appropriate donor contract or funding source clear. If activity-based cost accounting is used in your organization, the activity and its assigned code should appear on the documentation.

BOX 6. Questions to Ask During the Approval Process

- Are the desired goods or services required for the activity or for general operations?
- Is this transaction in accordance with the organization's policies and donor requirements, and with the rules of law?
- Is the pricing reasonable?
- Is there money in the budget to support this cost?
- Does this cost represent the best interest of the organization and those it serves, rather than the personal aims of staff or management?

ILLUSTRATIVE DOCUMENTATION BY EXPENSE TYPE

Invoices should be issued to the organization and not to individual employees, except for travel reimbursements, which will be in the name of the traveler. This indicates that the costs being billed are business, not personal, expenses.

In addition, all receipts and invoices must clearly identify the name and address of the vendor issuing the invoice, full details of the goods or services that were provided, and the itemized costs. Vouchers should be used. A voucher is a cover sheet that provides an at-a-glance summary of the transaction: check number, amount, account coding, activity coding, date of transaction, and approval.

Salaries and employee benefits. Documentation needed to pay salaries and provide benefits includes:

- signed, dated, and approved timesheets for each employee;
- spreadsheets or other records indicating deductions for taxes or other with-holdings;
- records showing, by employee, paid time off, pension, and other benefits;
- documentation regarding pay increases, approved by an authorized official;
- documented personnel policies and salary scales that outline the benefits an employee is entitled to and the withholding to which an employee is subject.

Consultant or subcontractor payments. The following documents should be required for these payments:

- a copy of the signed contract or consultant agreement outlining the payment terms and requirements for acceptance of the technical services;
- a scope of work;
- an invoice from subcontractor or consultant;
- written approval by the technical supervisor that the work is completed and its quality is acceptable.

Materials and supplies. Paying for materials and supplies requires:

- an approved purchase request or requisition order;
- an approved purchase order;
- a detailed vendor invoice;
- proof of receipt of all goods in usable condition and as specified;
- approval of the final costs and coding.

Rent and occupancy costs. Documents should include:

- the signed lease agreement;
- detailed bills from utility companies;
- rent receipt.

Equipment and capital assets. These are generally costly items that are durable and have a useful life of more than one year. The organization or its funder sets thresholds for the cost and useful life of equipment and other capital assets. There should be:

- a documented procurement process, including technical specifications, price quotes, and selection notes;
- approval of the board of directors or tender committee, if applicable;
- a vendor invoice;
- proof that the item was delivered and was in acceptable condition;
- information enabling you to trace assets to inventory records, such as serial numbers, model numbers, asset descriptions, date put into service, cost, and physical location of the asset;
- details about the disposition or retirement of assets that are no longer serviceable or needed.

Travel expense reimbursements. If travel expenses are paid directly by staff and reimbursed by the organization, the following documentation should be required:

- travel expense claims signed and dated by the traveler, including a complete itinerary stating the purpose for the trip;
- lodging receipts, if applicable;
- receipts for other travel costs such as taxi fares, airplane fares, and payments for visas;
- proof that the travel was approved by an authorized person or the donor before the trip.

In addition to documentation related to specific financial transactions, it is essential to have well-documented financial and operational policies and procedures. They provide the framework within which your staff perform their duties, and they set expectations for performance. These policies and procedures also provide the background against which your organization will be audited and held accountable by management, owners, and funders.

Funders often require clear, documented policies and procedures to provide evidence of a controlled environment and to assure that assets will be treated in accordance with sound management practices and in a manner that supports the mission. The importance of policies and procedures and guidelines for establishing and documenting standard operating procedures (SOPs) are discussed in the section "Using Policies and Procedures to Enhance Internal Control."

Conflicts of interest and unethical conduct

A conflict of interest exists when a person in a position of power or trust has competing personal or professional interests that make it difficult to carry out his or her duties impartially. For example, an employee could exploit his or her professional capacity for personal or professional gain by working for a competing employer.

A conflict of interest can exist even if it does not result in any improper acts. If the pubic might consider a relationship or action to be improper, even this possible *appearance* of a conflict of interest must be avoided.

TYPES OF CONFLICTS OF INTEREST

Several situations can create a conflict of interest or the appearance of a conflict of interest:

- Outside employment can cause the interests of one job to conflict or compete with the interests of the other.
- If a spouse or close relative is employed by a firm selling goods or services to your organization, an impartial decision may be, or appear to be, impossible.
- Hiring or promoting a close family member can appear to be nepotism—favoritism based on a family relationship.
- Gifts from friends or associates seeking to do business with your organization could be, or appear to be, a form of bribery.
- If a purchasing agent is given a bonus based on how much purchasing is under budget for the year, the financial incentive may motivate that person to purchase substandard items at the lowest price rather than to seek goods that represent the best value for the organization.

OTHER IMPROPER ACTS

The use of organizational or government assets and equipment for personal use or benefit is generally considered unethical. Such use constitutes fraud.

WAYS TO MITIGATE CONFLICTS OF INTEREST

The best way to handle conflicts of interest is to avoid them entirely, but this is not always possible. Ways to limit the influence of conflicts of interest include the following:

- **Recusal:** abstaining from participating in an organizational decision in which one has a real or apparent conflict of interest.
- **Disclosure:** publicly identifying any potential conflicts of interest so that it is clear if a decision might be unduly influenced.
- **Third-party evaluations:** hiring an independent, well-qualified, respected firm to make an organizational decision when the person who might otherwise make the decision has a conflict of interest.
- **Codes of ethics:** written guidelines that spell out expected behavior, actions to be taken when a conflict of interest exists, and prohibited acts.

Evidence of potential conflicts could cause donors to withhold business or lead competitors to file a complaint or make a public statement that damages the reputation of your organization. If public funds are used, claims of corruption could lead to legal suits, fines, or even prison terms. In addition, if your staff members feel that procurement staff are benefiting personally from their positions by receiving gifts or privileges from vendors for themselves or family members, low morale can damage the atmosphere and performance of your organization.

Chapter 3 of this handbook includes discussion about preventing conflicts of interest, especially for board members.

PREQUALIFICATION OF VENDORS

Although it is recommended that your organization use full and open competition to select vendors, doing this for every transaction can be time consuming and costly. One common technique that is useful for recurrent purchases, such as for office supplies or travel services, is prequalification.

To prequalify a vendor, follow the full procurement process to select a vendor that provides the best value for specific types of goods or services. Once the selection is made, this vendor can be qualified as the vendor of choice for that type of goods or services for a specified period (generally one year or less) and within a specified cost range. Using a **blanket purchase order/agreement**, you can use this vendor for future similar purchases without obtaining additional quotes or bids.

The process used and the prequalification criteria, including provision for review and recertification, should be thoroughly documented. This streamlines the process and saves time and effort.

Procurement management

Procurement encompasses the processes for purchasing or contracting for services and goods, including medicines and contraceptives. These processes may include commercial goods and services widely available in the marketplace or specialized technical services provided under contract by consultants and contractors.

Because a significant amount of your organization's financial resources is likely to be committed during the procurement process, sound procurement practices are critical. Policies and procedures should be in place to guide spending that is appropriate and ethical, and free from corruption, fraud, or employee self-interest. If public or donor funds are used, procurement may be subject to strict laws and regulations that prohibit bribery and acceptance of kickbacks (defined in Box 7) and require disclosure of potential conflicts of interest.

BOX 7. What Are Kickbacks?

Kickbacks are payments or other types of compensation made to influence and gain profit from an individual or company. In essence, kickbacks are bribes paid by potential vendors. An individual or company uses kickbacks to gain an unearned advantage, benefit, or opportunity over other potential suppliers, even if others are more qualified or offer more competitive prices. Both the giving and receiving of kickbacks are considered a crime in many countries because kickbacks interfere with the functioning of competition in the marketplace and with offering "a level playing field"—an equal opportunity—to all potential suppliers.

Your organization's policies and procedures for procurement must be documented in writing and shared with all staff in the position to purchase goods or services for the organization. Procurement policies and practices must comply with local law, generally accepted accounting practices, and donor requirements, when applicable.

Policies and procedures should also reflect the philosophy and values of the organization and its funders. Finally, procurement policies and procedures should be in the best interest of the organization but flexible enough to deal with additional requirements if you have multiple donors.

Two other basic principles apply to all procurement activities:

1. Personal preference should not factor into the purchasing decision. All offers should be considered objectively.
2. Procurement must be—and appear to be—open and fair. The organization is using other people's money, whether it comes from a donor, private contributors, owners, or stockholders. Proper stewardship of these funds is essential.

The use of donor or government funds might require additional rules or levels of complexity, including some that conflict with your organization's common practices or the standard business practices in your location. The organization must weigh its willingness and capacity to conform to these rules before accepting the funds. If you do accept the funds, your organizational policies, procedures, and operating structures must guarantee compliance with those requirements.

ESSENTIAL PROCUREMENT PROCEDURES

There are several procedures that an organization must follow when procuring goods and services:

- All procurements must be properly authorized before purchase, based on the internal controls and signatory authorities established within the organization.
- Procurements must be reasonable and necessary for the activities or operations.
- There must be adequate funding available to cover procurements. If funds are not in the budget, they must be raised, or a decision must be made to reduce or eliminate other costs.
- Purchase orders should be issued for the purchase of all goods except those purchased with petty cash. Purchase orders form the basis of an agreement between the organization and the vendor, spelling out the rights and responsibilities of both parties.
- The items purchased should be most advantageous to the organization when price, quality, and other factors are considered. The focus is on obtaining the best overall value and not necessarily the lowest price.

Open competition involves seeking multiple bids from potential suppliers, to help you obtain the lowest prices or best value. Open competition helps prevent collusion between purchasing agents and vendors that could lead to price fixing, bribery, kickbacks, or other unethical conduct. The level of competition should reflect the level of risk the organization faces and the consequences of an improper practice.

ELEMENTS OF SOUND PROCUREMENT PRACTICES

Common sense and practicality are important assets in developing procurement practices. For the sake of efficiency, processes and documentation requirements should not be more cumbersome than necessary for the risk involved. Generally, procedures cover various spending levels and become more detailed and complex as the risk increases. The processes should be applied uniformly for all purchases of a similar nature, scope, and size—regardless of who is receiving the goods or services.

Your organization should strive to select goods and services that provide the best value and recognize that value does not necessarily mean the lowest price (see Box 8). Purchases should provide quality for the money spent, meeting but not necessarily exceeding the selection criteria.

The criteria used and the analysis of the offers should be in writing and kept with the procurement files. A selection note is used to document how the selection was made and what criteria were considered. No conflict of interest should exist, or appear to exist, that prevents impartial selection or results in certain staff members reaping personal gain.

Items to be purchased must be clearly defined with technical specifications or a scope of work. This reduces risk, helps you obtain what you need, and clarifies your expectations for the vendor.

The correct use of procurement instruments—purchase orders, consultant letters or contracts, and subcontracts—is discussed in detail in a subsequent section.

BOX 8. Obtaining Best Value

Although obtaining a low price is always desirable, there are other factors to consider when determining which vendor is offering the best value. These factors include:

- the quality and features of the proposed goods or services;
- the availability and time of delivery of needed goods or services;
- additional costs, which must be added to base prices to reflect the full cost of an item. Examples are:
  - delivery and installation charges;
  - anticipated costs for routine maintenance, service, and replacement parts;
  - hidden costs related to inefficient operation of equipment, delays in delivery, or poor quality that affect other processes;
  - reputation of the vendor and its policies and practices related to warranties and guarantees;
  - payment terms.

Involve those who will use the goods or services to help you analyze quality and hidden costs and determine the best value.

THE PROCUREMENT CYCLE

Procurement generally follows the sequence of events outlined below:

1. Determination of need, as determined by asking:
   - What goods or services will be required?
2. Determination of procurement strategy, as determined by asking:
   - What type of purchasing mechanism will be used (e.g., purchase order, contract)?
   - What level of competition is required?
   - What policies and procedures are applicable to this type and magnitude of purchase?
3. Issuance of solicitation document, which generally includes:
   - a scope of work for services;
   - technical specifications for goods;
   - the selection criteria that will be used.
4. Selection of vendor, which should include documentation of how and why the choice was made, especially if the vendor does not offer the lowest price;
5. Negotiation of price and terms;
6. Final award of contract or purchase order to vendor;
7. Receipt of goods or services;
8. Closeout, acceptance, and payment, followed by filing the procurement documentation.

SOLICITATION REQUIREMENTS

Solicitations are requests issued to potential vendors when you wish to procure services, commodities, or other products. The format and content of the solicitation will vary, depending on the complexity of the proposed purchase. However, all solicitations should include:

- a clear and accurate description of the technical requirements for the material, product, or service to be procured:
  - In competitive procurements, such a description should not contain features that unnecessarily restrict competition to a specific brand or individual.
- requirements that the bidder or seller must fulfill as well as any other factors used to evaluate bids or proposals;
- a description, whenever practical, of technical requirements: functions to be performed or performance required, including the range of acceptable characteristics or minimum acceptable quality standards;
- the specific features that bidders are required to meet when such items are included in the solicitation;
- if desired, features such as energy efficiency, environmental friendliness, or other factors that are specific to the values of the organization.

Two common forms of solicitations are a request for quotation and a request for proposal, as described below.

Request for quotation (RFQ). RFQs are generally used for commercial goods and routine services. A vendor is asked to state the cost of the described goods or services. The vendor may also be requested to provide additional information, such as delivery time and charges, maintenance fees, and installation fees. You should let the vendor know which elements will be considered in the final selection process. The quotations provided are nonbinding but may become the basis for a binding purchase order.

Request for proposal (RFP). RFPs are generally used for procuring technical services. The resulting offers presented by potential vendors are binding, generally within a disclosed time frame. An RFP provides considerable detail about the work to be performed, the terms of delivery, and other criteria that must be met. If you take the time and care to craft a clear and comprehensive request, the result should be high-quality offers that can be easily evaluated.

PROCUREMENT INSTRUMENTS

A procurement instrument is a document or contract that binds the organization and vendor and details the terms of the sale. The type of procurement instrument used should be appropriate to the goods or services being purchased. It should provide all details required by the vendor to guarantee that the desired goods or services are provided within the time frame required. It should also document the price and payment terms agreed upon and any provision for cancellation or modification. These details help eliminate potential confusion, legal disputes, and financial claims.

Several common procurement instruments are outlined below. We have not provided specific examples because countries' legal requirements vary, and donor constraints might need to be included, if applicable. We have included the elements that you should include in each instrument to guarantee that it is accurate and adequately documented and that there is a clear understanding between your organization and vendors. The forms you use should be customized with your organization's logo, address, and contact information.

Purchase orders are generally used for the procurement of commercially available goods. They outline:

- the quantity and description of items to be provided (might include part or model numbers);
- the date by which the items are required to be delivered;
- the quoted price;
- payment and billing terms;
- delivery instructions.

A **purchase order** for services may be used for the procurement of administrative and support services such as accounting, office cleaning, office security, secretarial services, or legal services. These services are commercially available in the marketplace. A purchase order for services may also be used when the outcome of the service is more like a product. Training materials and translations of documents are examples of such products.

A purchase order for services generally outlines:

- the period of performance;
- a scope of work or terms of reference;
- the supervisor for the work;
- a list of any deliverables, such as a report, that must accompany the work;
- the price to be paid;
- payment and billing terms.

Consultant letters or **contracts** are used to procure short-term technical services from an individual. Such individuals are independent, and not the employees of other organizations or government agencies. Technical services are related to the organization's core mission and program activities. Such services could be provided by a staff member, but they may be procured from an external source for one or more reasons, as follows:

- The organization is short staffed.
- The service is required only for a short time and does not warrant hiring long-term staff.
- The organization's staff members lack the expertise or skills needed for the service to be provided.
- Training staff to perform the service is more expensive and less efficient than hiring an expert on a short-term basis.

Consultant letters or contracts generally specify:

- the level of effort the consultant is expected to provide (normally expressed in days);
- the daily rate to be paid for the services;
- an agreement on any travel or out-of-pocket expenses that can be reimbursed;
- the period of performance, the dates during which services are to be performed;
- a detailed scope of work that outlines the nature of the services to be provided;
- a list of related deliverables that must be provided, such as reports;
- a technical supervisor in the hiring organization;
- billing instructions, including to whom the invoice should be sent and by when.

A **subcontract** is used to procure technical services from an organization. Payment is made to the recipient organization, which subsequently compensates the individuals who provided the work. The solicitation should state what kind of contracting instrument will be used for the award. Fixed price or cost reimbursement subcontracts are the two most common types of subcontracts.

- A **fixed price subcontract** pays the organization providing the services a flat fee, regardless of the actual cost the organization incurs to provide the service. A fixed price award is less burdensome to administer, but it requires that both the offerer and the purchaser have sufficient knowledge and information to agree upon the fixed price.
- A **cost reimbursement subcontract** reimburses the provider for all costs actually incurred in providing the service, up to an authorized limit.

All procurement agreements, such as purchase orders for services, consultant agreements, and subcontracts, must be negotiated and signed *before* the work begins. Following this process means that all agreed-upon terms and prices are accepted before funds are committed.

PURCHASE REQUESTS

Purchase requests are internal control documents used by a staff person who identifies the need to purchase a good or service. This form is a means of obtaining prior approval from the budget holder or authorized manager and beginning a procurement process.

Purchase requests can be made through memos or email, but a standard form is recommended to summarize all the required information and serve as a vital piece of documentation for the procurement file. Purchase requests should include:

- complete and accurate specifications for the good or service to be purchased, including pricing information, when available;
- the quantity required;
- any associated services that are necessary (e.g., installation, ongoing maintenance);
- possible suppliers, if appropriate or known;
- the intended recipient and destination for delivery;
- the date by which delivery is required;
- any special contractual requirements;
- any special selection criteria.

An approved purchase request begins the procurement cycle and provides the initial information required by the purchasing agent or tender committee.

Travel management

In many ways, travel policies and procedures follow all the guidelines established for general procurement because transportation, lodging, and related services are being procured. There are some elements specific to travel, however, that you should consider.

Before you undertake improvement of travel procedures, analyze the types of trips your organization's staff take most often, as well as the factors below.

- Is most travel related to attending meetings or running errands in the local area? Travel to rural or remote regions to conduct program activities? International travel to attend conferences?
- Is travel conducted by most members of the staff, or is it limited to senior management?
- Are travel costs funded by donors? Donors often impose strict policies for travel and related costs.
- Does your organization own vehicle(s)? Are staff expected to use their own vehicles for business travel?

- What public transportation is available, and what is the state of the transportation system?
- Does your organization face other travel-related concerns?

COMPLYING WITH LAWS AND REGULATIONS

First and foremost, you must draft travel policies that require adherence to local laws and donors' requirements and put procedures in place so that these policies are consistently followed. If your organization has multiple funding sources, travel policies should either satisfy all requirements or be well documented and capable of being adjusted to comply with varied funding circumstances.

Some common requirements address:

- registration, taxation, and insurance of vehicles owned by the organization;
- liability insurance to cover medical costs and other costs of passengers if your organization's vehicle is involved in a traffic accident;
- policies regarding safe operation of vehicles, such as a prohibition against drunk driving and a requirement that drivers and passengers wear safety belts;
- limitation of the use of vehicles provided or supported by donors to official, not personal, use;
- restriction of travel costs (transportation and lodging) to economy or standard class, with business class allowed in some circumstances. (Most donors prohibit using their funding for first-class or luxury-class transportation and lodging so that more funding is available for program activities.)

Often donors and governments establish rates or methodologies for reimbursing staff for meals and other travel costs incurred during work-related trips. Procedures and policies must be established to ensure compliance with these regulations.

Your organization should also consider whether these policies will apply to travel funded through other sources. There are benefits to having a uniform travel policy, but implementing highly restrictive donor rules for all travel undertaken by the organization may not be in its best interest.

SETTING STANDARDS AND RATES FOR PER DIEM

If per diem and travel cost thresholds or policies are not prescribed by donors or government agencies, your organization will need to establish its own criteria. Among the elements to consider are the needs of the traveler:

- What types of business facilities will travelers require? Work demands often make services in hotels such as reliable Internet connectivity, well-equipped meeting rooms and conference centers, and other business services an essential element of travel.
- Are staff traveling to foreign areas? Will language, food requirements, or religious or cultural factors affect the choice of acceptable hotels or the costs of food and incidental travel expenses?

- What means of transport or agreements regarding travel days, stopovers, and the like will guarantee cost-effectiveness and the safety, well-being, and productivity of the staff?

KEEPING STAFF AND VEHICLES SAFE

Travel policies should include elements that safeguard the safety of the staff while in the organization's vehicles or while using public transportation. These policies will be influenced by the local environment. Common prohibitions, requirements, and limitations include:

- prohibiting or limiting travel after dark or on certain roads;
- prohibiting driving violations, such as speeding, and requiring staff to pay the fines for any violations from personal funds;
- requiring staff to wear safety belts;
- requiring that vehicles be adequately maintained and carry spare tires, basic tools, and first-aid supplies;
- requiring that company vehicles or rented vehicles be driven only by drivers who have proper training and experience, as well as any required licenses or permits;
- requiring that vehicles be guarded or otherwise secured at night or while drivers are waiting for passengers;
- limiting the types of local transportation that may be used and under what circumstances;
- limiting the use of low-cost airlines and transportation providers that have or have had known safety violations;
- requiring the selection of hotels or other lodging choices that provide adequate safety, security, and access to administrative services.

GUARDING AGAINST EXCESS AND ABUSE RELATED TO TRAVEL

Travel costs are closely watched by donors and the public because they are common areas for excess and abuse. General principles to apply are:

- All travel charged to your organization or passed on to donors must be for costs required to conduct or oversee program activities.
- Costs should be ordinary, necessary, and reasonable for meeting the planned work, considering the answer to three questions:
  - Is the proposed travel necessary? Could a telephone call or email achieve the same result?
  - Can the travel be coordinated with other travel needs?
  - What is the most cost-effective means of travel? Time for travel should be considered when calculating the cost. A bus ride that takes a full day may not be the most cost-effective mode of travel if a one-hour flight is available.

You will need to be attentive to the following:

- **Costs for premium-class transportation and lodging, and travel by family members:** Such costs are closely scrutinized. Costs that cover staff members' spouses and family members or weekend and holiday travel are also scrutinized. Travel by senior managers and board members is of special concern because this travel often can be a "perk" or benefit, rather than a necessity for work.
- **Costs for meals:** Meals should be reasonable for the work and location, but not lavish. The organization should consider whether the cost of alcohol will be allowable for work-related travel.
- **Flat rates versus reimbursement:** Whether the organization pays the traveler a flat rate or reimburses actual costs should be considered. Flat rates are generally easier to administer. They involve giving travelers a fixed amount per day to cover meals and lodging. A hybrid method is commonly used: it fixes the rate assumed to cover meals and small incidental costs, but reimburses only actual lodging costs, up to a maximum limit. Local law should be consulted because flat-rate per diem schemes often have income tax implications. For example, many countries impose income tax on meal allowances that exceed the actual costs of meals. Appendix H provides a guide for creating a per diem scheme.
- **Receipts:** Travelers should be required to provide original receipts that prove that they actually spent money for such services such as meals and lodging costs and transportation. Alternatively, a fixed daily allowance may be provided to cover meals, without presentation of receipts. The daily allowance must cover normal meals in the area where travel is conducted.

Finally, policies concerning travel must be fair for all staff. Any impression that travel and per diem are benefits for senior staff is likely to have a negative effect on staff morale.

PRIOR APPROVAL FOR TRAVEL AND TRAVEL PLANNING

In general, travel policies should require that all but routine travel be approved in advance. In addition, it is wise to require that adequate time be allowed to plan all but emergency travel. Prior approval is an internal control element for all procurements; some donors require prior approval.

Prior approval means there is an opportunity to assess if the travel is necessary for program activities and if there is adequate money in the budget to support the travel. In addition, planning travel well in advance allows the best chance of obtaining reasonable rates for transportation and lodging. Reasonable choices often sell out first. Transportation, especially airfare, often has much higher rates for last-minute purchases.

Starting early also provides an opportunity to plan coverage for needed tasks while the traveler is out of the office. Planning for the use of the organization's vehicles makes it possible to coordinate conflicting requests and combine trips and/or routes in a way that conserves time and fuel.

TOOLS FOR TRAVEL MANAGEMENT

Some basic forms should be in place to manage and control travel, as follows:

- **Travel authorization form.** This can be a modified purchase request form. In addition to obtaining permission for the travel from an authorized manager, the form should also be used to approve specific travel elements, including transportation, lodging, and meals or per diem.
- **Travel logistics form.** This may be a separate document or built into the travel authorization form. This form is used to gather details about the traveler's needs: travel dates, lodging requirements, transportation needs, and other costs such as conference rooms.
- **Travel expense report.** This form is used for reporting actual costs incurred. Original receipts are submitted with the form.

These forms will differ from organization to organization because they should reflect an organization's policies and work flow. Whether forms are paper or electronic, they must facilitate gathering and documenting essential information as well as approval from an authorized manager or budget holder.

Asset management

Fixed assets or **capital assets** are tangible, durable goods that are generally expensive and have an expected useful life of at least a year. Common fixed assets are furniture, office equipment, computer equipment, and vehicles. Cost thresholds and lifespan (for example, $1,000 unit cost and useful life of one year) are often established in local tax laws and generally accepted accounting principles and are linked to rules related to depreciating costs in accounting records.

Funders may impose their own definitions and thresholds, which may differ from the standards set by an organization. If your organization has multiple donors, you will need a robust system for tracking capital assets, including who ultimately owns the asset. Often the donor retains the ownership title.

DEFINING CAPITAL ASSETS

An organization may set a standard definition for all fixed assets, or there may be different thresholds for different types of assets.

The first component of a capital asset policy should be the definition(s) the organization will follow in determining which assets are capital assets. Defining capital assets should be done in collaboration with the accounting team or external auditors to ensure compliance with local law. The policy should detail types of assets, cost thresholds, and lifespan and should include a requirement that these definitions be applied consistently and uniformly. Procedurally, the accounting records should have separate accounts for tracking the various types of capital assets and their associated depreciation.

TRACKING CAPITAL ASSETS

In addition to the tracking that occurs through the accounting records, fixed assets must also be tracked through more detailed records and physical inventories. Some office furniture and equipment may not meet the organization's definition or thresholds for capital assets; items such as mobile telephones, office furniture, printers, and some computers may not be expensive enough to include in the capital asset register.

It is reasonable, however, to maintain a record of these items in some type of register to avoid giving the impression that they are not controlled, which might open the door to improper use or theft. For adequate management and control, details about the items, their location, and the staff member who has been entrusted with them should be documented.

All items purchased or received through donation that meet the definitions of capital assets should also be documented in an asset register. The register should include:

- a detailed description of the item;
- a unique identification number assigned by the organization and marked on the asset itself, making it easier to track multiple similar items;
- the date the item was purchased or received;
- the date it was disposed of or taken out of service;
- vendor information;
- model numbers and serial numbers, if applicable;
- location where the item is put into service: the office, the employee who has custody, etc.;
- title or ownership:
  - If an item was received from or paid for by donors, you should be careful to observe any rules about who has title to assets that might be included in the donor agreement. For example, the donor may retain ownership and request the items back at the end of a project or stipulate that they be delivered to another recipient.

The asset register. The register may be a handwritten ledger, computerized spreadsheet, or set of inventory cards. However, it is highly recommended that a computerized database or spreadsheet be used because it makes it much easier to sort and report on the data.

The asset register should be updated frequently, preferably as soon as the items are received or paid for. External auditors may ask to review the asset register to test the accuracy of the accounting records and depreciation costs.

It is important to have the asset register verified at least once a year through a physical inventory. The inventory should be conducted by an independent source, not the person in charge of receiving the assets or updating the register.

When assets such as computers or mobile telephones are given to staff, the recipients should be required to sign a document that indicates that they received the items and that they agree to safeguard them, use them only for work-related purposes, and return them when they terminate their employment. A copy of these documents should be kept in the employee's file. Upon termination, return of the items should be verified before the organization makes final payments to the employee.

Items that are used only occasionally, such as an LCD projector, should be kept in a secure, preferably locked, place. Staff should be required to sign the item out when they use it. The office manager or assigned custodian should verify that the item is returned to stock after use.

Policies should document the consequences if staff fail to safeguard or return your organization's assets. These consequences often involve a requirement that the staff person replace or pay for the repair or replacement of missing or damaged items. If the staff person leaves the organization without returning an asset, his or her severance pay or final wages may be reduced to cover the loss or damage.

Cash management

To follow the general principles of cash management, your organization should:

- store petty cash securely in a safe or locked box;
- limit access to cash and restrict its use;
- follow a complete procurement process to the greatest extent possible, and pay for purchases by check;
- implement a system for tracking cash advances issued and collecting overdue outstanding advances;
- provide evidence that cash was actually disbursed for the stated purpose and received by the intended recipient;
- use reputable banks or exchange houses for currency exchanges and document exchange rates;
- make sure employees use caution when transporting cash and limit the amount of cash they carry on their person;
- record all cash transactions in the accounting records and reconcile accounts monthly;
- limit access to bank accounts to the president, chief financial officer, chief of party or senior technical officer, and operations or finance manager;
- authorize the board or management committee to open a bank account;
- maintain a copy of bank records in the organization's records;
- permit expenditures for allowable work-related costs only, prohibiting personal expenses or expenses that are deemed unallowable by donor agreements.

CASH ADVANCES

Cash advances are generally issued to cover travel costs but may be issued to cover other work-related expenses that a staff member will be expected to pay for in cash. A request for an advance must include documentation about the purpose of the advance, and it must be approved by the appropriate manager.

A cash advance given to staff is a debt obligation between the individual and the organization. It should be limited to an amount that can be readily recovered, such as one month's salary. The terms for repayment or for clearing the advance through presentation of receipts and other documentation should be clearly defined.

The organization should set a policy about whether advances will be given against future wages, and, if so, under what circumstance. This is often not practical or allowable, and it is recommended that it be limited to extraordinary circumstances, such as catastrophic illness. The circumstances of such loans should be documented in the employee handbook and considered part of the employee benefits package.

PAYMENTS

For internal control purposes, almost all payments should be made by check or bank transfer. Payments that cannot be made by check but are larger than conventional petty cash transactions require complete documentation about the nature of the expenditure, as well as a signed and dated receipt showing that the cash was received by the intended recipient.

Blank checks should not be signed. A check should not be issued payable to cash but in the name of the person who will cash it. This practice prevents misappropriation if the check is lost or stolen.

All voided checks (checks to be destroyed because of a mistake) must be accounted for in the accounting records and the physical check rendered unusable, to prevent fraud. This is done by writing across the face of the check and removing any signature.

Put in place systems to make it possible to take advantage of any prompt payment discounts and to prevent incurring finance charges or late fees for failing to pay on time (these may be unallowable expenses). It is also necessary to guard against duplicate payments.

USE OF PETTY CASH

Petty cash is used for small, routine, or urgent purchases only and not as a means for avoiding the prescribed procurement systems and practices. Petty cash should be maintained as an **imprest fund**, meaning that the amount of cash and receipts in the fund must always equal the established fund amount. Petty cash is replenished only for the amount of completed receipts on hand. Although petty cash funds may seem inconsequential, they often provide temptations and are prone to misuse or inadequate controls, which can lead to financial losses over time.

Good practices for managing petty cash include the following.

- Keep petty cash in a locked box or safe and authorize access by a limited number of staff.
- Keep minimal amounts of cash on hand. The total fund should equal no more than approximately one month of anticipated petty cash needs, and it may be prudent to maintain a lower level.

- One person only should be the custodian of petty cash. For good segregation of duties, this is generally someone other than the accountant.
- Obtain signed receipts for advances issued from petty cash. Such advances should be small and very short term, generally for same-day purchases.
- Whenever possible, obtain receipts from vendors and attach them to the petty cash slips. If it is not possible to obtain a vendor receipt (for example, from a taxi driver), simple receipts, which may be purchased from an office supply store or printed on a computer, may be used.
- Someone who is not the custodian of the petty cash fund should reconcile and replenish the petty cash fund at least once per month. Someone else should approve the reconciliation and sign the replenishment check.

Internal control requirements and guidelines

All CSOs, NGOs, government agencies, and for-profit entities engaged in providing health services have the same obligations to their constituencies, whether they are citizens, taxpayers, owners, donors, or stockholders. These organizations are responsible for fulfilling a mission, often for the benefit of the most vulnerable populations. To carry out their responsibilities, they must have adequate management and operating systems, good internal controls, and competent staff. Services, materials, and supplies must be available for staff to carry out planned activities. Organizations must be able to account to donors and the larger society concerning the efficient and appropriate use of resources.

With the similarities in their obligations come similar desires and constraints.

- Each organization has a vested interest in protecting its assets—including cash, equipment, and real property—from theft, fraud, and misuse by management, staff, and people outside the organization.
- Donors want assurances that their funds will be used and managed wisely before they entrust them to a contractor or grantee.
- Boards of directors, government agencies, donors, and external credit sources want assurances that financial statements are accurate and timely.

This section explains the concept of internal control and the importance of supporting it with clearly documented policies and SOPs.

Internal control is an operating structure and a system of management policies and processes designed to provide reasonable assurance of:

- effective and efficient operations;
- control over and accountability concerning assets—including cash and equipment and other property—to safeguard against loss, theft, misuse, or unauthorized disposition;
- the reliability of financial reporting based on financial transactions that have been properly executed, recorded, and allocated;
- compliance with internal policies and procedures, generally accepted accounting principles, and sound management practices;
- compliance with donors' contract provisions and government statutes.

Adequate internal control is a function of sound policies and well-documented procedures as well as staff who are trained regarding these requirements and agree to comply with them. All staff should be trained in the procedures they will be called upon to use, including travel, timekeeping, and purchase requisition.

ELEMENTS OF INTERNAL CONTROL

In addition to establishing policies and procedures and conducting training, organizations exercise financial control by creating a controlled environment and segregating people's duties. These elements are discussed in subsequent sections. Other internal controls generally address administrative, accounting, and data processing functions.

- **Administrative controls** relate to decision-making and transaction authorizations, for example, the approval of timesheets, travel authorization, or approval of purchase orders.
- **Accounting controls** detect errors before financial transactions are recorded. Financial transactions include sales, purchasing, receipts of cash from sales or funding sources, payment of payroll, etc. Such controls ensure that the entries are in accordance with accounting standards, mathematically correct, and properly charged to accounts or budgets. Accounting controls help safeguard the organization's assets.
- **Data processing controls** guard against errors that might occur when financial or accounting records are input into computer systems and later reported in financial and managerial reports. Examples include use of passwords and access rights to prevent inappropriate entries, changes, or deletions of data.

Internal controls related to personnel, policies, procedures, and some other aspects of the organization's day-to-day functions are reviewed below.

Personnel

- Financial responsibilities and authority are defined in employee job descriptions.
- An organizational chart shows lines of responsibility.
- Finance and operations staff possess the needed education, training, and experience to carry out their functions, and they receive supervision and additional training as warranted.

Policies

- Policies are in place to guard against a conflict of interest, especially if it is related to staff who make procurement decisions.
- All affected staff have access to policy manuals.
- All affected staff are oriented to and trained on organizational policies when they are hired and throughout their tenure, especially when policies are added, modified, or rescinded.
- Policy manuals are reviewed, maintained, and updated routinely.

Procedures

- Written procedures are maintained regarding financial and accounting practices, account coding, and activity coding schemes (see Appendix D on coding and Appendix F on coding structures).
- Written procedures exist for travel and procurement.
- Expenses are controlled through the use of operating budgets, purchase orders, and travel authorization. These systems are documented and uniformly applied to all applicable transactions.
- Subsidiary accounts (accounts payable, accounts receivable, staff advances, and bank and cash accounts) are reconciled to the consolidated general ledger every month. Discrepancies detected during this reconciliation process can indicate weaknesses in the systems as well as possible financial malfeasance. As a manager, you must determine whether the size of a transaction error in a subsidiary account significantly alters the nature of a transaction or quality of a financial report. The cost or effort required to fix the problem may not be worth the effort.
- Financial records are subject to internal and/or external audit routinely, preferably once a year. All variances from budgets or expected results are documented and reconciled promptly, and disciplinary action taken when warranted.
- Standard forms and templates, such as travel authorizations, purchase orders, timesheets, and leave requests, are used for planning and documenting routine administrative activities.
- Procurement policies are documented and applied consistently to enable fair and open competition to the greatest extent practical.
- Best value is considered when making purchasing decisions.
- Purchasing functions are kept separate from accounting functions.
- Financial transactions and related operational activities are approved before the organization commits resources and in accordance with approved work plans and operating budgets.

Other Elements

- Checks and cash are maintained in a secure area, generally a fireproof safe, with limited access.
- Records are maintained of any prior approval required by donor agreement. This may include approval for international travel, purchase of equipment, or salaries.
- Records are maintained of any approvals issued by the board of directors.
- Any revisions to policy or procedure that are identified or necessitated through minutes of board meetings, memos from owners or senior managers, or new government edicts are promptly added to the organization's policy and procedure manuals, and staff are alerted of changes in processes.
- Systems are in place to ensure the appropriate business use of supplies, equipment, and other assets.
- Property and other assets are protected or insured to the greatest extent possible against theft, fraud, fire, or other catastrophic loss.

- Someone who does not normally have responsibility for receiving or tracking assets conducts a physical inventory at least once a year to verify the location and condition of all assets.
- Financial records are safeguarded and retained, as necessary.
  - Computerized financial records are archived for future reference and to satisfy tax, donor, and audit requirements. Computerized accounting and operations files are protected from damage caused by power outages and surges and are routinely backed up.
  - Paper documents are maintained in an orderly manner and kept on file for the mandated number of years to satisfy audit or donor requirements. Paper files are protected from fire and water damage.
  - Access to paper and/or computer files is limited to those who have a professional need and adequate authority, and sensitive and confidential files are maintained in password-protected files, locked files, or secure offices.

CREATING A CONTROLLED ENVIRONMENT

Written policies and procedures for operations and finance must be established, routinely reviewed and updated, and distributed to all staff. It is impossible to hold staff accountable for certain behaviors if expectations are not in writing and training is not provided.

Compliance with the stated policies and procedures is required, and an employee's failure to follow prescribed procedures should be subject to disciplinary action. Breaches are grounds for reprimand or dismissal.

Managers' roles and responsibilities related to financial dealings must be clearly defined in their job descriptions, and the managers must have adequate skills, knowledge, and authority to carry out their responsibilities. This should include nonfinance managers who have responsibilities for managing budgets or approving costs on behalf of their programs and projects. Support and program staff with responsibility for compliance must also be trained and have adequate skills, knowledge, and authority to carry out their roles.

When you and other managers demonstrate respect for policies, procedures, laws, and contract requirements, you will help create the right work environment for staff. As a manager, you must respond to all questioned costs and procedures uncovered during an audit process, whether conducted by internal or external auditors. Problems must be corrected and procedures put in place so that the problems do not reoccur.

Box 9 summarizes some of the actions your organization can take to create and maintain a controlled environment.

Monitoring. Safeguards should be in place to guard against fraud and misuse or theft of assets. Routine monitoring should include report reconciliation (a review tied to other sources such as bank statements or subsidiary ledgers), internal and external audits, and financial analysis to uncover problems and prompt action. Equipment, inventories (including medicines and contraceptives), and cash should be subject to routine physical counts and verified against written records. (See Chapter 8 for a section on inventory management.)

BOX 9. Creating and Maintaining a Controlled Environment

- Establish and disseminate clear, written policies and procedures.
- Have policies and procedures reviewed routinely and modified as necessary to reflect the current situation.
- Train or retrain staff in the policies and procedures that apply to their work.
- Set aside time and resources to address operational issues and complete necessary tasks, such as procurement.
- Address the human factors that may cause employees to avoid rules and procedures that are time-consuming or restrictive.
- Make sure that staff understand the reasons for internal controls and operational policies; compliance is more likely when the why is communicated.
- Employ a best practices model, engaging staff in a performance improvement activity to strengthen financial and organizational management, rather than simply imposing what might appear to be arbitrary rules.
    - This process is likely to result in the same procedures being adopted and increase the likelihood that they will be followed.
    - When staff members have participated in creating new practices and feel that the practices make them more efficient, successful, and up-to-date technologically, they may be proud to comply, rather than feeling constrained by rules.
- Enforce existing policies uniformly and consistently.
    - Official consequences foster compliance.
    - If some people are allowed to bend or break the rules, others will tend to ignore the rules as well.
- Model expected behavior with regard to compliance with sound financial management principles.
    - If senior managers set an example that shows they value fiscal responsibility and appropriate behavior, the rest of the staff is more likely to exhibit these behaviors as well.
- The computer system(s) used for financial recording and reporting must have data entry controls, access controls, and security controls, including the use of passwords and other mechanisms.
- Computers should be protected—by means of uninterruptible power sources and routine file backup procedures—from damage or loss of data due to power fluctuations. In addition, antivirus and hacking protection should be installed and routinely updated.

Your organization should hire professional external auditors to review financial statements. They generally also perform an assessment of internal control and management systems.

But because auditors may focus more on the internal controls related to accounting, you might want to explore the control systems of broader operational activities, either using the organization's staff or with the assistance of a paid consultant. The assessment tool QuickStart is a good starting point for this internal review. QuickStart's assessment will provide you with a comprehensive understanding of the basic elements of internal control and cash control that should be present in your organization's accounting and financial management systems.

Prompt corrective action must be taken to deal with irregularities and noncompliance uncovered by monitoring and audit activities. In the case of CSOs, the board of directors is responsible for seeing that this standard management practice is carried out. Chapter 3 of this handbook offers information on the role of the board in providing financial oversight. Staff and donors alike will take notice of leaders' actions, as noted in Box 10.

Organizations with small or inexperienced accounting staff should undertake more frequent or stringent internal or external audit reviews to verify that sound practices are being followed and financial transactions comply with policies and contractual agreements. A grantor or donor will probably require stronger monitoring and audit requirements for such organizations than for those with more experienced accounting staff.

SEGREGATION OF DUTIES

A fundamental principle of sound internal control is the concept of segregation of duties. See Box 11 for examples. To the maximum extent possible, financial duties should be distributed among staff in a manner that prevents one person from having control over all phases of any financial transaction. Without adequate checks and balances in place the opportunity exists for funds and other assets to be inappropriately used or reported as the result of error or fraud.

Job descriptions should clearly articulate the various roles and responsibilities within the finance and administrative staff. The fiduciary responsibilities of managers, such as authority to sign checks, approve expenditures, or open bank accounts, should also be incorporated into job descriptions. Signatory authority lists should detail any limits to the amounts or types of expenditures that may be authorized. Large financial transactions often require dual signatures.

BOX 10. Don't Underestimate the Power of Leadership

- If staff observe senior managers complying with policies and procedures, they will feel more inclined to act the same way.
- Rank and privilege do not come with permission to bend the rules but with the responsibility to model expected behavior.

BOX 11. Examples of Segregation of Duties

- The person who authorizes purchases or expenditures does not issue the payments to vendors.
- The person who records transactions in the accounting records does not issue the payments.
- The person who issues checks for payments does not reconcile the cash and bank accounts.
- The person who prepares the payroll does not distribute the paychecks.

Segregation of duties can be difficult in a small organization. A senior manager such as the chief financial officer, at a minimum should approve large expenditures before they are made. The definition of "large" will vary from organization to organization and may be defined by both monetary value and type of expense. However, all purchases of equipment and furniture fall into the large category. It is common for the board of directors to play a role in authorizing the largest expenditures.

In organizations with multiple levels of budgetary authority, there is often a range of thresholds for prior approval that are assigned to the various managerial levels. The roles, monetary limits included in the approval authority, and any limits on the types of transactions that these roles can authorize should be detailed in writing and circulated to staff.

After the transaction has been executed at a lower level, a senior manager should examine the expenditure documentation, sign the checks, and review and approve the bank reconciliation reports.

The use of tender or procurement committees to review and approve substantial purchases also plays an important role in a controlled financial environment. Some segregation of duties can also be achieved by assigning some tasks to nontraditional positions, such as receptionists and secretarial staff.

Using policies and procedures to enhance internal control

Clear and comprehensive policies and procedures related to finance and operations are essential to an efficient and controlled work environment. Because they provide the framework within which staff are expected to conduct themselves and carry out various functions, they must be accessible to all staff, part of orientation, and updated as circumstances require.

You can refer to Box 1 to refresh your memory about definitions of policies and procedures.

THE NEED FOR DOCUMENTATION

There are several compelling reasons why your organization should thoroughly document expectations regarding financial management, office operations transactions, personnel management, and purchasing.

One practical reason, and often the one that initiates documentation activity, is that a potential donor is likely to require such documentation as evidence of adequate business capability. The requested policy documentation will generally cover cash and asset management practices, procurement policies, travel management, and personnel management, including compensation, benefits, and supervision systems.

These policies and procedures vary from organization to organization, due to local law, the environment, donors' regulations, clients' expectations, and strategic decisions made by the board about the use of resources. However, there will be many similarities stemming from compliance with generally accepted accounting standards, common ideas about sound business practices, and ethical conduct.

Auditors are also likely to examine policy and procedure manuals, practices for reviewing and approving expenses, and standard forms and templates as part of their review of your organization's financial situation.

Benefits of complete, up-to-date documentation. In addition to pragmatic reasons such as satisfying auditors' scrutiny or meeting donors' requirements, having well-articulated policies and procedures offers important benefits to your organization.

- Policies and procedures provide a framework and context for employees. Without them, work becomes a series of costly and inefficient trials, mistakes, and corrective actions. When policies and procedures are in place, the desired result is more likely to be obtained the first time.
- Documented policies and procedures record for posterity the lessons learned, so that future actions will be completed more easily.
- Written policies and procedures create a framework for holding employees accountable for poor performance or financial malfeasance. Clear policies and procedures help eliminate ambiguities; without them, it is harder to distinguish deliberate attempts to commit fraud or deception from simple human errors or misunderstandings.
- Documented policies and procedures help define the roles, responsibilities, and decision-making authority of staff and members of the board of directors.
- Comprehensive policies and procedures free up your time as a manager to do your job. Subordinates who are clear about their responsibilities are generally free to carry out their work without seeking constant guidance or additional approval.

HOW TO DOCUMENT POLICIES AND PROCEDURES

If your organization does not have well-documented policies and procedures, creating them might seem like a daunting task involving a review of policies, procedures, and work flows for logic, efficiency, existence of necessary internal controls, segregation of duties, and accuracy. To make the task manageable, it is generally best to start with small pieces, rather than attempting to create the entire policy manual at once.

If you and other managers begin by identifying key activities in each operating area, you can document the policies and procedures related to those activities. For example, purchasing a plane ticket might follow a routine process that you could document by writing down:

- the steps that must be taken to purchase a ticket;
- any rules imposed by the board, senior management, or the donor related to this purchase (such as a prohibition against purchasing a business-class airplane ticket or a requirement to have advance approval for international travel);

- the key players in this process, for example, the requestor, approver, purchasing agent, or vendor;
- definitions for all terms that might be unfamiliar or need clarification.

A sample template for documenting SOPs and capturing the elements of a process appears in Appendix I of this chapter. The template, which includes hints for completing the form, is a suggested format and model for documenting policies and operating procedures in a comprehensive and clear manner.

We provide this model for organizations that are just beginning the documentation process. If your organization uses a different model to document policies and procedures, we recommend reviewing your format to make sure the following eight elements are present:

1. **Purpose:** What does this policy statement and related procedure define?
2. **Revision history:** Have changes been made to an existing policy or process? If so, record the date, revision number, and reference section, and briefly describe the change.
3. **Positions affected:** Which positions does the policy or procedure affect, and what are the responsibilities involved at each step of implementation?
4. **Applicable policies:** What rules of the organization or donor govern the activity being defined?
5. **Definitions:** What terms and acronyms need to be defined because they might not be familiar to all staff?
6. **Procedure:** What are the detailed procedural steps to follow?
   a. Include all steps, clearly articulated, to prevent confusion. Having people from different parts and levels of the organization review the procedures is useful.
   b. Review whether the current practices are logical and efficient. Can steps be eliminated or improved to increase efficiency? Do internal controls need to be strengthened?
7. **Responsibilities:** What roles are played by the various people affected? For example, do they request, approve, implement, or document?
8. **Reference materials:** What copies or links to related forms and other reference materials are needed? These materials will build the knowledge people need to execute the procedures or comply with the policy. The materials may be on paper or in electronic files shared through a computer network.

If any of these elements are not covered by your organization's format, consider modifying it to include them. It is highly recommended that, as much as possible, you use a standard method and format to document all policies and procedures so that your staff become comfortable with the presentation.

Policies may come from a variety of sources:

- decisions made by the board and recorded in board meeting minutes;
- emails or other memos from senior management circulated to staff;
- applicable laws or donor regulations;
- the organization's mission and value statements.

Once the SOP is drafted, it is important to review it carefully and test it with the staff involved in all stages of the process. Obtaining various perspectives will help you see any problems with the process or the documentation.

The review process should include the following questions:

- Is the work flow complete?
- Is the responsibility for each step clearly defined?
- Is the process logical?
- Are adequate internal controls built into the process?
- Is the policy statement clear and accurate?

Your organization will want to verify all policies. Many operating procedures evolve from de facto policies or practices that have never been formally approved by management or reviewed to be sure that they reflect the organization's mission, strategic objectives, and standards. A historical precedent should not become a policy or operational standard without being reviewed and purposefully accepted.

As individual processes are documented, a complete policy and procedure manual will begin to take shape. Generally an introduction, documentation of overarching principles, and a table of contents are all that are needed to complete the manual. Developing SOPs in this way, one by one, results in a manual that is easy to maintain because individual SOPs can be updated without rewriting the entire manual.

Proven practices

- Senior management and the board of directors must demonstrate that financial accountability and compliance are expected at all levels of your organization. If it appears that rules apply only to subordinates, compliance throughout the organization is likely to diminish and the possibilities of fraud might increase.

- Organizational guidelines in the areas of financial management and procurement should prohibit fraud and embezzlement, and forbid all staff from giving or receiving bribes and kickbacks or having inappropriate financial dealings with family members.

- Financial policies and standards of practice for essential accounting and office operations functions should be clearly documented and shared with all staff. As a manager, you can make sure that orientation, training, revision, and review occur on a routine basis.

- Financial policies and procedures should be crafted in a way that protects your organization from risk. These policies and procedures should comply with applicable laws and donor requirements and should support the organization's mission and financial goals.

- It is a good idea to seek professional guidance from labor lawyers and taxation specialists to ensure that your organization's policies and practices are in accordance with all applicable laws. These complex areas often fall outside the expertise of staff accountants, and noncompliance or evasion can result in significant penalties or legal action.

- Be sure to hire finance and operations staff with appropriate education and work experience. The risks associated with tax and labor issues and audit findings far outweigh any perceived savings from hiring less specialized staff. Some small organizations obtain high-caliber staff by hiring part-time employees, contract employees, or consultants.

- Good internal control and financial oversight begin long before transactions reach the accounting office. If you dedicate time and resources to making sure that purchasing systems, travel, and office management systems work together, your organization's money will be spent wisely.

- The principles of good internal control and financial oversight should be built into organizational systems. These principles are: obtaining the best value for your organization; adhering to previously budgeted and approved spending limits; and complying with government, donor, or management policies that determine allowable costs.

Glossary of accounting and procurement terms

ACCOUNTING TERMS

account reconciliation: Determination of the items or adjustments necessary to bring two or more related statements or accounts into balance. For example, reconciliation is frequently used to balance field accounts with corporate accounts, or bank accounts with corporate accounts.

accounting: The language, processes, and procedures of business that are used to measure, record, report, and interpret the financial aspects of an organization.

accounts payable: Bills to be paid. *See also* **liabilities**.

accounts receivable: Money to be collected from others. *See also* **assets**.

accrual basis accounting: An accounting methodology in which expenses are recorded on the books when they are incurred and income is recognized when it is earned, regardless of when cash to complete the transaction actually changes hands.

activity-based cost accounting: An accounting methodology that calculates the full cost of an activity, project, or service through the allocation and attribution of support costs.

amortization: Reduction of an amount over time, often used to spread major expenditures that were paid in a lump sum over future accounting periods.

assets: The cash, property, inventory, and equipment owned by an organization or due from others, such as clients or donors.

balance sheet: A record of the assets, liabilities, and equity of an organization.

balanced books: The fundamental principle of accounting, by which assets must equal liabilities plus equity. What an organization owes must be offset by what it owns.

budgets: Expressions of expected future income and expenses. They are based on historical data, if available, and adjusted based on assumptions about inflation, increases/decreases in income or expenses, and expansion. Budgets are a tool to monitor organizational performance.

capital assets: Durable equipment, furniture, and fixtures, generally costly, that are expected to have a long useful life and be available for the organization's use for an extended period. The organization generally sets limits on both the cost and life expectancy of items considered capital assets. *Also called* **fixed assets**.

cash basis accounting: An accounting methodology in which expenses are booked when cash is disbursed to satisfy an obligation. Income is recognized when the payment is received.

cash flow statements: Financial reports that help managers predict the needs for cash and the timing of income and expenditures. They provide an analysis of the inflow and the outflow of cash and provide an indicator of the organization's ability to meet its short-term obligations.

chart of accounts: A listing of code numbers and descriptions that itemize the types of income, expenses, assets, and liabilities that will be accumulated, tracked, and reported.

chief financial officer (CFO): The executive with full financial authority and responsibility. The CFO's duties include financial planning and oversight of appropriations and expenditures, record-keeping, and financial reports.

commodities: Manufactured goods, agricultural products, or natural resources that are bought and sold in the commercial marketplace.

compliance audit: Examination of specific financial and administrative transactions to determine whether they were performed as prescribed by law, donor contract or agreement, and organizational policies or specified purpose.

conflict of interest: A personal connection that might influence one's ability to make an impartial decision related to the organization's financial dealings. For example, a purchasing agent with family or business ties to a potential vendor would have a conflict of interest.

credit: In double-entry bookkeeping, the entries in the right column of the paper ledger. Revenue, liabilities, and owner equity generally appear as credits. In computerized systems, the credits are normally expressed as negative numbers. In double-entry bookkeeping, the credits must equal the debits.

current assets: Cash and other assets that can be converted to cash in less than one year, such as accounts receivable.

debit: In double-entry bookkeeping, the entries in the left column of the paper ledger. Assets and expenses generally appear as debits. In computerized systems, the debits are normally expressed as positive numbers. In double-entry bookkeeping, the debits must equal the credits.

depreciation: A periodic diminishing of the value of a capital asset over the expected lifetime of the asset, to reflect usage of the asset.

equity: Reserve or net worth of the organization, calculated by subtracting the value of liabilities (what is owed) from the value of assets (what is owned).

exchange rate: The ratio of one unit of currency to another.

expenses: The cost of doing business (resources procured), including supplies, wages, and services paid for.

financial audit program: The scope of work and procedures to be carried out by auditors when examining financial records and accounting practices. It includes a description of the work to be performed, the time frame to be examined and the time frame for the review itself, and personnel to do the audit, as well as an indication of the scope of the investigation.

financial obligation: An agreement to hand over one of the organization's assets, generally cash, in exchange for goods, services, or other assets.

fixed assets: Equipment, furniture, or fixtures required for operation of the business and not intended for sale to customers. They have an expected useful life of more than one year and are generally depreciated over time. *Also called* **capital assets**.

fixed costs: Costs to which the organization is committed and which do not vary based on current operations and activities, such as rent.

fully loaded costs: Costs of operations and activities that include both the direct costs for the activity and the indirect (overhead) costs, including general and administrative costs.

general ledger: The primary financial record of an organization. All financial transactions are recorded in it, either in detail or summarized from other journals or ledgers.

imprest fund: A cash fund that is maintained as a fixed amount, with cash replenished based on the exact amount of the expenses incurred. Petty cash is generally maintained as an imprest fund.

income: Money earned through operations, sales, donations, and fees for services.

income statement: A report of the organization's income and expenses. *Also called* **profit and loss statement**.

incurred costs: Costs related to transactions that have occurred, even if they have not been paid for yet.

internal control: Procedures and policies that regulate how financial transactions occur in an organization. Some points of focus include prior approval of expenditures, cash control, including prompt bank statement reconciliations, and accurate documentation of costs.

liabilities: Long- and short-term debts owed to outsiders, including banks, investors, and vendors.

net profit/loss: The difference between total income and expenses.

operational audit: An examination performed by an internal or external reviewer to determine if an organization's operational policies and procedures are efficient and appropriate. It looks at organizational structure and controls as well as the ability of management to adhere to policies.

petty cash: A limited amount of cash kept on hand and used to pay for small, routine, or urgent purchases.

revenue: Money generated through the sale of goods and services performed by the organization and from donors that is available to pay operating expenses or make capital improvements.

sunk costs: Major costs that have been incurred, such as for the organization's property, capital equipment, and vehicles, etc., and which do not vary based on the organization's program activities. *See also* **fixed costs**.

value vs. price: Value is what a good or service is worth, or what it costs to produce it. Price is what the customer is willing to pay to obtain the goods or services.

voucher: Document used to capture the details of a financial transaction, including authorization and approval.

PROCUREMENT TERMS

best value: The trade-off between price and other performance factors—such as quality, delivery time, and warranties—that provides the greatest overall benefit in light of selection criteria.

blanket purchase order/agreement: A standardized format used when multiple, recurrent purchases are anticipated for the same goods or services and that will not require reoccurring bids or quotes.

kickback: Payment or other type of compensation made to influence and gain profit from an individual or company. Essentially, kickbacks are bribes paid by potential vendors.

request for proposal (RFP): A form of solicitation, generally used for procuring technical services, which provides substantial detail regarding the work to be performed and the terms of delivery and other criteria which must be met.

request for quotation (RFQ): A form of solicitation, generally used for commercial goods and routine services, in which a vendor is asked to state the cost of the described goods or services.

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Appendices

APPENDIX A. Sample Balance Sheet

NGO Nonprofit
STATEMENT OF FINANCIAL POSITION*
FOR THE YEAR ENDED DECEMBER 31, 20XX

ASSETS			
	Current Assets:		
		Cash on Hand	** 95,000
		Donations Receivable	150,500
		Prepaid Rent	5,000
		Prepaid Insurance	2,000
		Total Current Assets	252,500
	Long-Term Assets:		
		Unrestricted Investments	125,600
		Restricted Investments	400,250
		Furniture, Fixtures, & Equipment	535,900
		Less: Accumulated Depreciation	(350,000)
		Total Long-Term Assets	711,750
		TOTAL ASSETS	** 964,250
LIABILITIES AND EQUITY			
	Current Liabilities:		
		Accounts Payable	** 35,275
		Accrued Salaries and Wages	15,800
		Other Accrued Expenses	9,800
		Total Current Liabilities	60,875
	Equity:		
		Unrestricted Equity	27,450
		Restricted Equity	875,925
		Total Equity	903,375
		TOTAL LIABILITIES AND EQUITY	**** 964,250**

* This is a sample of a balance sheet, also referred to as a statement of financial position, for a small, nonprofit NGO. The content will vary from organization to organization but the common elements are:

- it is a snapshot of the financial position on a given date;
- it is organized in two sections: Assets and Liabilities and Equity;
- the sum of assets will always equal the sum of liabilities and equity;
- it is generally organized into current and long-term sections.

** Insert the symbol for the currency here.

APPENDIX B. Sample Income Statement

NGO Nonprofit
STATEMENT OF SUPPORT, REVENUE, AND EXPENSES*
FOR THE YEAR ENDED DECEMBER 31, 20XX

SUPPORT AND REVENUE			
Support:			
	Donor Awards and Grants		** 450,000
	Public Contributions		15,000
	In-Kind Contributions:		
	Equipment		29,000
	Facilities		5,000
	Services and Volunteer Labor		17,650
		Total Support	516,650
Revenue:			
	Training Fees		32,500
	Royalties from Publications		10,050
	Fees for Services		17,600
	Income from Investments		4,250
		Total Revenue	64,400
		TOTAL SUPPORT AND REVENUE	** **581,050**
EXPENSES			
Program Activities			
	Salaries, Wages, Benefits		** 125,850
	Travel		29,450
	Supplies		11,425
	Other Expenses		15,000
		Total Program Activities	181,725
Development Activities			
	Salaries, Wages, Benefits		32,000
	Travel		9,500
	Supplies		1,750
	Other Expenses		2,950
		Total Development Activities	46,200
Fund-raising Activities			
	Salaries, Wages, Benefits		29,750
	Travel		8,350
	Supplies		3,280
	Printing		2,450
	Shipping and Couriers		1,295
	Other Expenses		2,300
		Total Fund-raising Activities	47,425

General and Administrative		
Salaries, Wages, Benefits		49,625
Travel		7,500
Supplies		12,550
Rent and Office Expenses		27,525
Insurance		2,450
Printing		3,100
Shipping and Couriers		1,250
Other Expenses		6,325
	Total General and Administrative	110,325
	TOTAL EXPENSES	**385,675**
NET EQUITY		** **195,375**

* This is a sample statement of support, revenue, and expenses for a small, nonprofit organization. A similar financial report for a for-profit organization is referred to as an income statement or a profit and loss statement. A sample statement of support, revenue, and expenses:

- reflects cumulative results throughout the period;
- is organized in sections that reflect support and revenue (or income) and expenses.

The difference between revenue and expenses is a change in net equity that flows to the balance sheet, or statement of financial position. In a for-profit organization, a positive net result is a profit, and a negative result is an operating loss.

** Insert the symbol for the currency here.

APPENDIX C. Attributable and Allocable Costs

Attributable and allocable costs are components of the technical activity category, in that a direct link may be made between the cost incurred and an activity or project. For ease and efficiency of accounting, these costs are given special consideration. Identifying attributable and allocable costs accurately allows your organization to know the true cost of conducting its technical activities or programs. It also serves to reduce the costs that might flow to general and administrative costs (often called overhead). Many funders are reluctant to fund costs for the general operations of the organization but will fund defensible costs for carrying out public health interventions.

ATTRIBUTABLE COSTS

Attributable costs cannot easily be directly charged to a single activity, often because it would be too time consuming or costly. To give an extreme example, office supplies are needed for several different, but identifiable, activities or programs, but it would be a time-consuming accounting activity to track each time a pen was used. Although it might be more accurate to attempt to direct charge nearly all costs, it would be too laborious to track the use of every piece of paper or pen.

It would also not be reasonable to purchase separate supplies for each activity because it is generally less expensive to buy in bulk. Your organization might opt to do an attribution of costs at the end of the month, based on well-thought-out percentages and assumptions about usage by the different activities. Cost distribution should be done in a method that is fair, uniform, sensible, consistent, and documented. The cost of supplies, staff, or equipment used only for a specific project or activity would be attributed to that project only.

As an example, you could pool costs specifically related to conducting training and later attribute some of those costs to those training activities, but not to unrelated service delivery activities.

Some traditional overhead costs may also be attributed to program activities using a rational cost formula. For example, the rent for the office might be broken down based on the head count of the organization's staff. Individual programs could be charged a portion of the rent, based on the number of staff who work on that program.

ALLOCABLE COSTS

Allocable costs cannot be directly linked to a single programmatic activity or project but are necessary for its successful completion. Note that these costs are exclusively for programs, unlike those indirect costs that are considered general and administrative for the entire organization.

One way to handle allocable costs is to post them to a cost center that is then allocated at the end of the financial period using some predefined, logical method. For example, if managers' efforts contribute to more than one project, an activity code can be created for project management costs that indicates the projects to which the costs are posted in the accounting system. At the end of the accounting period, all expenditures posted to the project management code are distributed among project activities based on a ratio. One methodology would be to allocate the costs in proportion to the direct expenses for the activity based on budgets and work plans for the year.

It is possible to estimate the rate at which project management costs should be applied to projects. This rate is often called the allocable cost factor (ACF).

If you are soliciting a donor for additional funding to expand a program or for a new project or activity, it is necessary to include the anticipated direct costs of the new or expanded project in the projection of the ACF. The rate will likely go down from prior periods because the project management costs will now be distributed over a larger base of direct project costs.

How to Calculate an Indirect Cost Rate (Organization-wide Overhead Rate)

The formula for an indirect cost rate is as follows:

total indirect costs ÷ allocation base (generally total direct costs for program activities, minus exclusions)

This indirect cost rate can be applied to the direct costs of a project or activity to calculate the full cost of that project or activity. Exclusions from the allocation base often include major expenditures for equipment or vehicles, construction projects, or pass-through funds going to grantees or subcontractors that might distort the rate.

Appendix D provides a more detailed example on calculating indirect cost rates.

If an indirect cost rate is being developed for a donor-funded activity, it is important to also exclude from the calculation any unallowable costs outlined in the donor's cost principles.

Note that donors may negotiate a ceiling on indirect cost rates. In this case, indirect costs may be billed only up to the ceiling amount, regardless of the actual final rate. The organization will need to identify another source of funds to cover the remaining costs.

Tip: Use a separate chart of account numbers to segregate allowable indirect costs and unallowable and allowable direct costs in your financial records.

Careful consideration of all attributable and allocable costs is essential for creating budgets and reporting financial results. These fully loaded costs become the basis for setting prices in a fee-for-service environment. If it is determined that the full costs cannot be recovered, a conscious and informed decision may be to subsidize the cost of some activities. It must be remembered that the overruns must be recovered from somewhere, be it a donation or other highly profitable services in the portfolio. Failure to cover costs will, over time, eat into capital reserves and jeopardize the survival of the organization.

What Is a Fully Loaded Cost?

A fully loaded cost is the true cost of an activity or project. It includes all direct costs, including allocable and attributable costs, as well as the applicable portion of the organization's indirect or overhead costs.

APPENDIX D. Indirect Cost Rates

Indirect costs are not identifiable with any one project, program, or activity, but they are essential for conducting these activities and are incurred for the overall operation of the organization.

Indirect costs are sometimes referred to as general and administrative costs. Typical indirect costs include:

- occupancy costs, such as rent and utilities;
- depreciation on nonproject equipment;
- general-purpose activities, such as telephone, postage, photocopying;
- salaries for staff in support services such as accounting, building maintenance, business management, secretarial services, or office of the president.

Although some types of costs are traditionally either direct or indirect, it is not possible to make a broad statement about them. The nature of a cost is determined by which programs or activities benefit from it, and to what extent.

It may be possible to shift some traditionally indirect costs to direct costs if it is possible to reasonably determine the cost driver and accurately apportion costs among programs or activities. The burden of determining the allocation to direct charges should be considered. If a donor has caps or ceilings on indirect costs, it is often worthwhile to create coding and accounting methodologies that allow for more precise direct charging of costs, so more costs can be recovered. For example, occupancy costs might be apportioned based on the number of staff or the square footage used, rather than booked to an overhead account.

Simplified indirect cost rate = indirect cost pool / allocation base
(generally total direct costs minus exclusions)

For an allocation base to be acceptable, it must be capable of allocating indirect costs equitably to all awards and contracts, regardless of whether they will actually be recovered from individual donors. For US Government (USG) awards, the key principle is that the USG is willing to pay its full share, but no more than its full share. There are rare instances when a government agency agrees to pay many indirect costs, more than its fair share, specifically to support the start-up or expansion of an organization that helps it reach its program objectives. However, this is generally done when there is a plan to achieve financial sustainability in the near future.

Some costs may distort the rate, so they are often eliminated from the base. Common exclusions include major equipment, large subcontracts, and construction costs.

Multiple allocation base method. If an organization has very different programs that require a substantially different level of overhead support, it can create multiple rates using different allocation bases. This is often difficult to justify and requires a sophisticated accounting system and greater financial analysis than is necessary for a single rate.

If a rate is being developed for a USG-funded activity, it is important to also exclude any unallowable costs from the calculation. Details on unallowable costs and indirect cost rates for US Government awards may be found in the Office of Management and Budget Circular A-122.

Indirect cost rates must be applied equally to all direct projects, regardless of whether they are limited by donor ceilings. The costs must be recognized even if they cannot be recovered.

FRINGE BENEFITS

Just like overhead rates, fringe benefit rates are subject to review and audit by donors. Fringe benefits should be put in a pool that can be allocated to donor projects based on direct wages charged. This ensures that labor-intensive programs receive a fair proportion of related labor costs, such as paid holidays, sick time, vacation, employer taxes, and insurance.

Some fringe benefits are mandated by law. Others are discretionary and are used to attract and maintain qualified staff. Common discretionary benefits include pension plans, life insurance, and health plans. Employee morale costs may also be included in fringe benefits. Such costs might include an employee cafeteria, day care center, or recreational facilities.

Fringe benefit rate ($) = fringe benefit expenses (including leave) / total salaries net of leave

Once the fringe benefit rate is determined, it is possible to apply the rate to direct salaries as they are charged. This is far easier and more accurate than trying to allocate the benefit costs when they are actually paid. The fringe benefits charged to indirect salaries flow to the indirect cost pool.

It is preferable to accrue vacation and other fringe benefits monthly and put a cap on the number of days that may be carried forward. This method ensures that liabilities for vacation, sick time, or other fringe benefit obligations are budgeted for and subtracted from available cash. This also prevents a problem that would occur if the program which incurred the liabilities for the benefits was no longer active when the benefits were actually taken.

Example of a holiday, sick, and vacation rate. For one person, the total person-days of work possible = 52 weeks × 5 days per week, or 260 days.

Paid time off:

Vacation	20 days
Sick	10 days
Holiday	12 days
	42 days

Paid work days = 218 days (260 – 42 = 218)

It would be reasonable to assign 218 days of a project person's wages as direct charges and put 42 days into the fringe pool.

Provisional rate: An estimated indirect cost rate, before final costs are known. Used for budgeting and billing purposes.

Final rate: The actual indirect rate, after the completion of financial statements, when true costs are known. Donor billing is generally adjusted up or down to correct provisional rates to actual. Final rates are generally verified by an independent auditor.

Note that donors may negotiate a ceiling on indirect cost rates so that indirect costs can be billed only up to the ceiling amount, regardless of the actual final rate.

INDIRECT COST PROPOSALS

Required documentation. Several documents are required for an indirect cost proposal to the US Agency for International Development (USAID):

- indirect cost pool schedules by cost element;
- identification of unallowable costs excluded;
- identification of other costs excluded, such as major equipment purchases;
- schedule of labor: job title, salary, direct or indirect classification;
- explanation of the allocation base used;
- identification of donor contracts;
- reconciliation of costs to financial statements.

MANAGEMENT OF INDIRECT COSTS

It is important to pay attention to the management of indirect costs, as well as programs. An organization that controls its indirect costs is more marketable to donors. Changes in the indirect cost rate may be indicative of the organization's financial health. When overhead rates go up, either indirect costs have risen or program costs have fallen. It is important to understand which is occurring so that appropriate measures can be taken.

Comparing rates. It is not a simple task to compare rates among organizations. It is necessary to understand factors such as what their allocation base is and what costs have been excluded. It is more important to pay attention to the equity of the rate, rather than the rate itself. One organization may go to great measures to direct charge everything. Another might allow many costs to flow to overhead.

What is most important is the overall cost to carry out the activity, not necessarily the distribution between direct and indirect costs. Presentation of the costs, however, may influence a donor's willingness to pay. A lower overhead rate may be easier to market.

APPENDIX E. Selecting and Preparing to Implement Accounting Software

All organizations, regardless of size, must be concerned with operational control, human resource management, and financial management. Modern automated accounting systems can make performing these functions more efficient and allow staff to "work smarter." It must be stressed that this software is a tool that provides the data and structure that help a business manager make sound decisions. Computerized systems cannot think or make business decisions. Nor can the new system eliminate all errors, although it should provide features to verify data accuracy to the greatest extent possible. Automated accounting is only one part of a well-organized business system.

Although office automation is a major capital expense, it is most sensible to regard it as an investment in the organization. If the right software is selected and then correctly installed and implemented, it can pay large dividends. Computerized accounting has moved away from pure bookkeeping into management information systems and operations support, providing services to areas of the company not previously directly served by the accounting system.

IDENTIFYING SYSTEM NEEDS

Throughout the needs definition process, each staff member should focus on the internal customers they serve. What system features can help them meet the needs of these customers in a more accurate, timely manner? In addition to satisfying the requirements of auditors and tax and statutory bodies, the new systems can facilitate budgeting and forecasting; enhance project and program management, planning, and control; help prevent fraud; and provide nearly instant access to information.

To capture some of the additional information desired, such as better allocation of expenses by donor or project, more data will need to be collected during transaction processing. This could increase processing time for some routine functions, such as accounts payable and payroll. The benefits of gathering additional data must be balanced with the amount of time, labor, and associated cost to collect it. If data will not be used, reconsider whether it should be gathered just in case.

PLANNING FOR THE UPGRADE

The organization may be forced to accept compromises during the process of upgrading the accounting system. Slower data entry may be a necessary tradeoff for access to much more data and increased efficiency in generating financial reports. The flexibility of writing checks daily might need to be exchanged for the efficiency and accuracy—and reduced frequency—of batch entry of computer-generated checks. To allocate personnel costs accurately to projects or departments, the current timekeeping systems will probably need to become more sophisticated. Decisions will have to be made regarding what present operational standards and processes must be changed to support and feed into the new financial system. If selecting a particular software would force changes unacceptable to the organization, it should be eliminated from consideration.

It is important to discuss these possibilities with staff to eliminate surprises when the new system is put in place. Since the new system will require new processes, staff should be consulted, or at least informed, about these upcoming changes. Change is stressful, even if the changes are positive, and staff members' coping skills will vary. Frequent communications, involvement in decision-making and system design, and training will help minimize anxiety. The more users are included in the planning and implementation, the easier it will for them to adapt to the changes.

The upgrade of a financial management system may add tasks and responsibilities to people's jobs. As the nature of these changes becomes clearer, job descriptions should be changed and new tasks assigned. Current staff may lack needed skills and require training or even reassignment. New recruitment may be necessary.

The success of a software implementation depends on having a solid manual accounting system prior to starting the process. It is important to analyze the present system to determine areas that need strengthening. These improvements should be made before implementation begins. Some areas that require particular attention are the chart of accounts, internal control, and records management. All journals, bank accounts, and the general ledger must be in balance before the installation begins.

Although automated accounting will eliminate the need for many of the handwritten journals, the computer will create a new set of reports and audit trails, and they must be retained. Arrangements will need to be made for safeguarding tape backups and archives, including routinely storing critical data off site, so it will be possible to restore the system in the event of fire or other damage to the office. Before the start of installation, organize a cleanup of files, deleting or archiving records that are no longer needed, and arrange office space to maximize comfort and access to needed hardware, such as printers.

The increased reliance on computer-generated information may cause increased noise and heat from printers, processors, and perhaps generators, or cause bottlenecks as staff gather around printers waiting for output. Small changes to office layout may improve these situations, which, although seemingly minor, may become major annoyances over time.

Other factors that will foster successful software implementation are information gathering, a methodical approach to the process, the cooperation of all staff members, the committed support from management, and patience. Implementing the new software will be an evolution, not an instantaneous event. The process must be allowed to follow its natural course. Timelines are only targets, which should be modified in favor of doing thorough analysis, planning properly, and starting up with accuracy. Chapter 2 has information that can help you lead and manage through this change.

SOFTWARE SELECTION

During the software selection process, gather as much information as possible about the possible software solutions, vendors, value-added resellers (organizations that buy hardware and software from manufacturers and sell it to the general public), and what the staff hope to get from the new system.

You may be tempted to expect the new system to satisfy every desire of every staff member. There are systems on the market that can do virtually everything, if you are willing and able to pay for them. However, the goal is to select the software that matches most needs and desires and satisfies all critical requirements at an affordable price. Highly sophisticated systems can offer too much technology, which is difficult to control and will probably frustrate finance staff if they are inexperienced with computerized systems.

TIPS FOR UPGRADING SYSTEMS SUCCESSFULLY

- Appoint a project manager to oversee the entire process. This person will coordinate meetings with vendors, assign tasks to staff members, and update management and staff on progress made and what to expect next. Since this will be a time-consuming task, the person should be given the time and resources needed to do the job.
- Appoint a steering committee of key staff members from the accounting, operations management, and project management groups to make decisions about the features required and final software selected. Also include staff members will be responsible for daily data entry. The computer network administrator should also be asked to provide a perspective on hardware and memory needs. The committee members will work with their departments or project staff to define needs and requirements and communicate results.
- Review and update the current accounting manual to accurately reflect the current system.
- Analyze the current systems and procedures for inefficiencies and make whatever corrections are possible prior to implementation. These changes should be reviewed with your accounting group or audit firm, if you have one.
- Be sure that the present system is balanced and reconciled. Any corrections and adjustments resulting from the current audit should be completed.
- Contact references and current clients of the software vendors you are considering. Discuss their successes and problems with the software and vendor service. How has the software improved their operations and decision-making? Were there any disasters? Compare the reference organizations' size, complexity, and system design with those of your organization to assess how the software might operate in your organization's environment. Ask the vendors' clients if they would select the same software and vendor again.
- Appoint someone (possibly the project manager) to create and maintain the project plan and supporting documents. Correspondence, responses from vendors, and minutes from meetings should be stored for future reference. In the worst case, this documentation might help settle a dispute with the vendor.

QUESTIONS FOR SYSTEM USERS AND VENDORS

- What are your present needs? How well does the software being presented meet these needs?
- What are your future needs or desires? How well does the proposed software meet these? How extensive will modifications be to accommodate growth or procedural changes?
- What features or functions will be improvements over the present system? How well does the proposed software solve current problems?

- Are the data-entry screens easy to use? How long will it take to enter routine transactions? Is this speed and performance acceptable? Have those responsible for data entry evaluated these features?
- Does the menu structure clearly lead you to desired functions?
- What level of online help is available? Is on-site help available? At what cost?
- What kinds of manuals and training materials are provided? Are they easy to read?
- Is this application too complex? Will it improve or hinder daily operations?
- Would all classes of employees who use the system be able to do so comfortably? Are advanced computer skills required?
- How much training will be required for staff members to become skilled enough to operate the system? Who will provide this training? At what cost?
- How much customization will be required to meet minimal requirements? Desired requirements?
- Are third-party applications required to perform standard functions, such as reporting or payroll? How are these applications supported? Is the integration between the packages seamless?
- How are budgets input and updated? Are budget tools sophisticated enough to meet project management needs?
- Does the software interface with other tools, such as spreadsheets, form letters, or creating charts? How easy is this?
- Can the vendor's clients currently using this software be contacted for references?
- Which standard reports are included in the software application? What tools are available for creating custom reports? How difficult is the report design to use?
- Do any features affect the operation of the software system in the current business environment? Is this problem solvable? If not, consider alternate software.
- Did the vendor seem well-informed about the software? How well does the vendor understand accounting and your business needs?
- How long has the vendor been in business? How many staff or consultants will be provided to install and implement the software and train staff?
- Did the vendor instill trust about their ability to provide service, support, and training after installation? Would you and others be comfortable having a long-term business relationship with this firm and salesperson?
- What were your first impressions of the software? Did those initial judgments change after further experimentation and demonstration?

APPENDIX F. Tips for Implementing Accounting Software

PREPARE FOR CHANGE

Change always brings risks and fear, based on the abandonment of the familiar and known in favor of the unknown. Have faith that the change will ultimately lead to an improved work environment. Embrace the opportunity to learn new skills, concepts, and practices. The new accounting system should position your organization to perform more effectively in the upcoming years. Chapter 2 has information that can help you lead and manage at times of change.

COMMUNICATE WITH STAFF TO FOSTER THEIR COMMITMENT

The success of the software implementation is directly connected to how committed the staff are to learn what the software can do, devote the time necessary to prepare for the installation, thoroughly plan for the new system, and work through difficulties as they occur.

The entire organization, not just the finance department, needs to commit to graciously accept the minor disruptions in service that will be necessary for completing the implementation. The results—increased efficiency and quicker access to management data—will be worth it.

The installation and implementation period will pose many challenges, especially as people try to balance the demands of daily work and the additional tasks related to the system implementation. Leadership and teamwork will be necessary to meet these challenges. If you communicate regularly with staff members, they will know what to expect, and when. Also, if you keep communication channels open, they will freely share their questions and concerns with you.

HOLD PROGRESS MEETINGS

The implementation phase will span two to four months. It will be necessary to hold frequent progress meetings to keep all staff, managers, and the board informed of progress and to alert the vendor to problems and training issues.

ASK QUESTIONS

Throughout the installation, implementation, and switch to the new system, numerous aspects will be confusing. The vendor is an expert who is available to answer questions and clarify processes. Use that company's expertise. The only bad questions are those that go unasked.

DOCUMENT, DOCUMENT, DOCUMENT!

- Keep very detailed paper trails of all installation decisions, such as master file and lookup table contents. Save these documents for troubleshooting problems at start-up and also for review by the auditors, if necessary.
- Maintain a complete project file that includes the resource materials and reports that have already been prepared. Consolidate all information from

vendors and consultants, along with the implementation plans and documents. These documents should be kept readily available for review.

READ THE MANUALS

To supplement training sessions and on-the-job learning, all members of the accounting staff should read the system manuals. These manuals will document features that might not be thoroughly covered in training and describe in greater detail how the various modules and processes link together.

DEVELOP A TEAM OF STAFF EXPERTS

Some staff members will find the new system easier to use because they have greater aptitude or experience with computers. Encourage these "stars" to coach and train others who need assistance.

UPDATE THE ACCOUNTING MANUAL

The accounting procedures manual must be updated to include new procedures, new forms, and the revised chart of accounts.

DETERMINE CODING STRUCTURES

- Ask the vendor to provide the architecture of the master files, so the coding structure can be set up accordingly.
- Decide whether all existing accounts payable vendors will be added to the system or if they will be added one at a time as they are used. Since vendor information changes frequently or many vendors are only used once or twice, it might be sensible to add only the common vendors at first.
- Decide what levels of detail you want to capture, such as department, project, donor, and location—or more. Remember that each additional level of coding increases data-entry time, so your choices should be based on real business information needs.
- To the greatest extent possible, incorporate currently used coding structures into the new system. The more familiar things seem, the easier the transition will be.

PREPARE FOR DATA ENTRY

- Update the chart of accounts to include all accounts currently in use. Decide on any additional accounts you would like to add.
- Reconcile all bank accounts.
- Be sure the trial balance is in balance.
- Gather all data on bank account numbers, addresses, etc.
- Gather all data on vendors that must be entered into the system, including any recurring monthly payments.
- Prepare a listing of all open invoices remaining to be paid. To the greatest extent possible, pay all outstanding bills to minimize data to be carried into the new system.
- Prepare a list of any open purchase orders.

- Prepare a list of all accounts receivable still due.
- Have employees verify all personal data that will be entered into the payroll module. Prepare a record of all wages paid, deductions, allowances, and tax information from the current fiscal year that must be entered.
- Prepare, or gather, all budgets for projects and departments.
- Assess the set-up of the accounting department offices. Determine if the computers and peripheral hardware are placed so they will be fully used. Some employees will spend a lot of time doing data entry, so be certain that their work areas have proper lighting, seating, and are equipped to prevent repetitive stress injuries.

ESTABLISH SECURITY PROTOCOLS

- Decide who will have system administrator or supervisor's rights.
- Decide who will have access to the various software modules and what level of access they will have (such as the ability to add, delete, or modify records) and set up passwords accordingly.
- Determine backup procedures, including off-site storage and storage of critical backups in a fireproof safe. It should not be the sole responsibility of the local area network (LAN) administrator to back up the accounting system because routine full LAN backups (done daily as a matter of good practice) may not be frequent enough to safeguard valuable financial data. The accountant should always back up financial data before running any critical transactions, after processing large amounts of data, etc. This is especially critical in areas that are prone to electricity fluctuations, power outages, or lightning strikes that can seriously damage or destroy electronic files.
- Computerization is not the creation of a paperless workplace! Set up a plan for report storage and distribution because computer reports may be bulkier and more numerous than those currently in use.
- Locate the printer(s) so that confidentiality of reports or checks is not compromised. Since the accounting area will generate a lot of reports, it should have at least one dedicated printer.
- Decide what types of transaction reports are desired to create adequate audit trails. Because some transaction reports are snapshots of data at a specific time, they cannot be recreated later.
- Decide which backups should be retained, and for how long, and which can be overwritten, and how long they must be available before being overwritten.
- When setting up system security, be sure that there is enough redundancy of skills so that if someone is out of the office, all functions can still be performed smoothly.

NOTIFY STAFF OF WORK SCHEDULES DURING IMPLEMENTATION

- Installation on weekends or evenings usually causes less disruption of daily routines but may mean extra time commitments from the staff. Be sure expectations are clear.
- Will there be any expected delays in processing vendor payments or other accounting office activities? Alert staff or others to this possibility.

- Notify all staff of training commitments that will limit the availability of finance staff.
- Notify the auditors, donors, and board of directors if the implementation schedule will delay the preparation of year-end statements. Work with the vendor to alter the schedule if those deadlines cannot be missed.

DEVELOP A TRAINING STRATEGY

- Decide who will be trained. Distribute the training schedule to all staff involved to ensure their presence at all required training sessions. Have sufficient training materials available for all staff, and set aside adequate time for successful training.
- Schedule training sessions and set up the training rooms to minimize distractions and interruptions. Notify all staff when trainings are in session, so meetings or other disruptions do not interfere with the lessons.

PLAN FOR THE USE OF COMPUTER-GENERATED CHECKS

- If you intend to generate checks using the computer, obtain the printing specifications and order checks early, to ensure that they are available when the system is installed.
- Be sure to get check writing supplies that are compatible with the available printers, or make a decision about purchasing a more appropriate printer model.
- Are several types of checks required for accessing different bank accounts or for payroll? Be sure to order all the needed checks; lower prices are usually available for bulk orders.
- Make a policy regarding when, or if, manual checks will be written, because processing manual checks requires additional data-entry time and may sidestep normal internal control procedures.

ESTABLISH PROCESSING PROTOCOLS

- Make checklists of the processing steps required for running various routines. These lists will be helpful until procedures become second nature. It will be necessary to remind staff about performing backups and running certain transaction reports.
- Determine how often transactions will be posted to the general ledger and by whom.
- Decide how source documents will be prepared for data entry. Since the computer will allow for the collection of additional data, it might be helpful to design cover sheets or rubber stamps that simplify the coding process.
- Who will review and audit batches? How will transactions be corrected?
- Develop a mechanism for tracking additions to vendor lists, personnel lists, and the general ledger. Decide who is authorized to make these additions.
- Since the accounts payable module allows for posting to past periods, it should be decided whether this is a desirable option.

- Decide which reports should be printed routinely. Although a software package typically allows you to print more than 250 reports, it doesn't mean you should!

CONSIDER NEEDS FOR SUPPLIES AND HARDWARE

- Be sure to have adequate supplies of paper, toner, backup tapes or disks on hand because these needs will increase as a result of the computerization.
- Determine if additional computers, printers, electricity regulators, generators, and related equipment are required and make arrangements to purchase them. Budget for system support or upgrades after the first year.

SCHEDULE A PARTY!

Set a target date for when the new system will be fully functional, and plan to celebrate all the hard work and commitment that made it possible to get the new system successfully up and running.

SCHEDULE A MIDTERM REVIEW

Several months after implementing the new system, after any glitches have been resolved, do a systematic review of the system. Workloads should be assessed. Some people's jobs should have become streamlined as a result of the computerization. It may be possible to reassign tasks, take on new activities, or take advantage of new proficiencies.

APPENDIX G. Planning for Risk and Developing a Project Risk Action Plan

Risk remains a secondary issue only as long as an organization's luck holds out or until a grand opportunity is missed.

Carl L. Pritchard
Risk Management Concepts and Guidance

Risks include failures to satisfy quality, budget, or performance objectives. Each of these risks would cost time and money, and possibly lose opportunities. The goal is to prevent injurious risk, but it is not always possible.

MANAGING RISKS SHOULD BE COUPLED WITH MANAGING OPPORTUNITIES

Some risk is desirable because it presents opportunity and the potential of profits, success, or other benefits. Most people fear and avoid risks more than they like and accept the challenges presented by opportunities. However, taking risks can be tied to reaping rewards. It takes wisdom to avoid or prevent the risks that will damage a project and courage to accept the risks that will benefit it.

Risk management is not an instinctual reaction to events. It involves a culture within the organization of protocols and practices that are consistently applied. The most critical phase in the risk management process may be risk detection. How can you know when you are about to encounter risk?

Risks. Risks have three common elements:

- an event
- probability of occurrence
- cost or loss if the event occurs (severity)

Opportunities. Opportunities also have three common elements, the first two of which are the same as those for risk):

- an event
- probability of occurrence
- profit or benefit if the event occurs (impact)

You must attempt to quantify consequences and probabilities in realistic terms, especially the costs or benefits that might be achieved. To the greatest extent possible, this should be a scientific and mathematical exercise, although "gut feelings" do play a part in the quantification of risk. See Box G-1.

BOX G-1. Quantifying Risks and Opportunities

Risk: Potential for an event to have negative consequences

Opportunity: Potential for an event to have positive consequences

Risk = "Cost" of unwanted event × probability of event's occurrence

Opportunity = Benefit of hoped-for event × probability of event's occurrence

Successful risk management requires an environment that allows and encourages honest and open communication about possible risks. If managers are discouraged from bearing bad news, valuable time that could have been used for mitigation or contingency planning may be lost. Opportunities may also be lost. If you are responsible for monitoring risk, be sure to clearly communicate the risks and potential consequences, as well as the possible opportunities, to those empowered to make decisions.

STRATEGIES FOR DEALING WITH RISK AND OPPORTUNITY

Strategies for dealing with risk follow:

- Accept the risk and take any loss, but be sure that the project team and management know.
- Avoid risk, and miss potential opportunities as well.
- Control risk through contingency and mitigation.

Strategies for dealing with opportunity are:

- Passive: Take an opportunity if it comes along.
- Active: Pursue opportunities actively.

The time and resources required to do risk planning are likely to cost far less than dealing with the consequences of a risk event. The greater the advance notice of risk, resulting from good project planning, the greater the possibility to compensate for or avoid the problem.

SOURCES OF RISK

There are external and internal sources of risk. Risks from external sources include:

- fire, famine, flood, war, and disease (environmental);
- changes in laws or regulations (governmental);
- loss of market share, introduction of competitors, and loss of suppliers (economic).

Risks from internal sources include:

- changes in board of directors' strategies and priorities, or funding agencies' politics;
- stakeholder changes;
- subcontractor failures, scheduling delays, cost overruns, technical surprises;
- loss of key staff;

- schedule delays and cost overruns due to poor planning and budgeting (e.g., unrealistic or incomplete).

There are inherent risks from project plans that are imposed by donors, customers, or senior management who desire results faster, cheaper, or with more functionality than is reasonable. Project managers must be honest enough and brave enough to point out these risks and substantiate them with sound, detailed budgets and schedules.

RISKS RELATED TO FINANCIAL MANAGEMENT

Some risks are related to financial management rather than to a specific project. Examples include:

- failing to stay informed about the true costs of doing business;
- assuming you can make up losses by delivering a larger volume of services. If you are generating losses, larger volume might only create larger losses;
- depending on donors;
- setting prices too low, for example, so you can win a contract;
- failing to scan and monitor the changing environment;
- condoning poor budgeting, planning, and reporting practices;
- not taking advantage of opportunities;
- not covering overhead costs.

PLANNING TO DEAL WITH RISK IN A PROJECT OR PROGRAM

> *Sooner or later, bad things happen to good projects, and a project manager without a clear strategy will pay a price.*
>
> Carl L. Pritchard
> *Risk Management Concepts and Guidance*

All major projects or programs should have some documented risk management activity in the scope of work and a documented risk management plan in circulation.

Risk events, probabilities, and impacts are unlikely to remain static over the life of the project. The longer the duration of the project, the truer this statement becomes. Therefore, the steps that follow should be undertaken continuously throughout the project. Risk identification and monitoring should trigger further planning.

Step 1: Identify risks. Identify sources of potential risk and specifically define them, including the likelihood of occurrence and the costs if the risk event occurs. It is important to describe the potential risk event in specific detail. Ask questions such as: How would it occur? What might occur? How seriously would it affect the project or the organization?

Don't forget to look at the possible benefits that might be gained from a risky opportunity.

Have a team of people looking at risk. Their varying perspectives, attitudes, and experiences with risk; their visions; and their tolerance for negative outcomes or risk-taking will give you a more balanced view of the potential risks. Include both risk-averse people and risk-takers.

Throughout the project, you should also make a point of getting a fresh perspective on potential risk events from experts or sources outside of the project itself. Staff members who are deeply involved in a project—including yourself—may be oblivious to changes in the environment that could result in new risks.

A good way to identify all potential risk events is to create a structure for the project, if you don't already have one. By breaking processes and activities into their smallest components, it is easier to readily identify risks that might remain hidden if you focus only on the big picture. Ask:

- What activities do we always follow?
- What are the core processes for these activities?
- What are the key elements and subactivities of these processes?
- What risks are common to these?

In addition, the team has a responsibility to research the history of other, roughly comparable projects. No project, no matter how advanced or unique, represents a totally new system. Projects originate and evolve from existing or past projects. There should be documentation of the risks encountered in those projects and the mitigation and contingency techniques used. The new project team should review those documents and use the lessons learned—or be destined to repeat them.

Step 2: Create a risk management plan. A risk management plan is an important tool to document and share risks and opportunities throughout the project. The components of a risk plan are:

- risk identification;
- risk assessment (probabilities);
- risk quantification (costs);
- response development (mitigation plans and contingency plans);
- a monitoring and control plan.

Create a matrix of possible risks to the project by asking:

- What risks can we avoid?
- What risks must we take?
- What risks can we ignore for now because the probability of their occurring is extremely low?

Identify possible risk events and break them into smaller events that are easier to control. Do this early, even in the development stage of a project.

Specifically define the risk event and estimate the probability of occurrence and the cost if it does. If it is not possible to scientifically document probabilities or assign accurate dollar values, it is possible to use percentages or high-medium-low scales. Clearly communicate the probability and cost of risk events to decision-makers.

Once you have identified the resident risks (the ones generally expected for the given activity), you can build in control mechanisms to deal with them. (See Box 2.) This should

BOX G-2. Resident Risk: Project Management Examples

A common resident risk is that an activity will fall behind schedule. There may be a good reason to allow a project to run late (such as waiting for legislation to be passed). However, this should be a conscious decision, not an unconscious one. A project should not fall behind schedule simply because someone was not watching the clock.

Another common resident risk is that the project will lack resources (not enough, not available at the right time, or not the right ones). Securing adequate resources (especially people) and ensuring that they are available when the project requires them is an essential task for the project manager and should be properly addressed in the risk management plan.

be done as part of project planning. This preparation will free up time and resources to deal with unexpected things that occur during project implementation.

One way to identify risks is to draw on the history of past projects and the risks they encountered and solutions they used to mitigate them. Using consistent forms and protocols to capture these lessons makes it easier to record and later interpret this information. Consider the following questions:

- What happened?
- Why did the event happen?
- How did it happen?
- What was the corporate, project, and market environment at the time?
- Who was involved?

You should also consult with experts, brainstorm with the project team, and use data from similar projects (gathered from journals, institutional memory, and other organizations).

Your task will be easier if the lessons learned were recorded at the time they were recognized; time dulls the memories and details. Many projects err by waiting until the end of the project to try to recall lessons learned. This may be several years from the time of the actual events and might be colored by the glow of the eventual success of the finished project.

As a manager of a health program or health services, you can make risk identification easier for your organization and others in the future if, at the time they occur, you document, share, and archive your own project risks and opportunities, their consequences, and subsequent actions.

Step 3: Design mitigation and contingency plans. To effectively manage risk, an organization should establish a plan to identify potential risks, quantify the impact they would have on the organization, and outline strategies to prevent them from happening (through mitigation planning) or limit their damage (through contingency planning).

The organization should develop a triage process for managing its risks. Determine and react first to the risk events that pose the greatest threat, not those that seem to cause the greatest commotion. Hospital emergency rooms use this technique to categorize patients according to who faces the greatest risk of serious complications or death and then treating them first. Triage involves the careful following of established protocols that are taught to all medical students, such as assessing physical appearance, mental state, and recognized symptoms.

All employees should understand the work environment and know the protocols for handling risk events. Similar to the hospital triage example, the organization should establish protocols for identifying potential risks, identifying those that could result in serious injury or "death" to the organization, and selecting the appropriate responses to manage these risks.

Mitigation is a before-the-fact technique. Having identified what could happen, the probability that it will, and how damaging the results would be, you can take steps to reduce the probability that the risk event will take place. Normally this is done for the risks with the highest probability and/or with the most severe potential impact on the organization. Taking precautions to prevent a fire or diminish its impact by purchasing fire extinguishers, backing up critical data off site, and conducting fire drills are examples of mitigation strategies. In keeping with the health analogy above, mitigation techniques are similar to routine medical check-ups, immunizations, and other preventive care.

Contingency is an after-the-fact technique. It involves having plans in place that can be quickly mobilized in the event that the unfortunate event occurs. By carefully identifying possible risks, it may be possible to identify possible solutions. Contingency provides a "cure" for the consequences after a risk event has occurred. For example, you might be able to identify sources of rental office equipment or temporary quarters to be used in the event of a fire. It is wise to build schedule and budget reserves into project plans to cover risks that cannot be mitigated.

Some risks stand out as "showstoppers" that would result in the "death" of the project or program, or even the entire organization. If these occur you cannot achieve your goals. The possibility of this type of risk might mean that the activity should not be undertaken. It is critical to know when to discontinue an unsuccessful or too risky activity. Determine what loss is considered acceptable as well as what is unacceptable. What cost can your organization accept? What risk can it endure?

Many organizations suffer huge setbacks because they prefer to keep projects on the equivalent of life support rather than make the difficult decision to end the project and move on. The answer to these questions will vary among organizations based on their financial reserves, ability to cover losses, and even the overall optimism or pessimism of the organization's leadership.

It is necessary to determine which risks are worth an investment of time and energy. Some risks are worth taking, because their severity is low or the probability of their occurrence is low (or both). Some risks are worth taking because the opportunities and gains they represent are great and can be controlled with proper management, planning, and project execution.

There are two forms of risk acceptance: passive and active.

Passive risk acceptance means accepting a risk without doing anything to resolve, manage, or cope with it. Note the key word: acceptance. Ignorance of risk is not appropriate.

Active risk acceptance means acknowledging that risk exists without planning for mitigation. Contingency plans or reserves are put in place instead.

When you design mitigation and contingency plans, it is critical that such plans not take longer or cost more than the project itself! Risk management techniques should not trigger additional major risk.

When you are developing responses, a good technique is to brainstorm multiple options. Then you can analyze them to determine which ones can be implemented quickly, with the lowest cost or project impact. The goal is to implement strategies with the greatest overall positive impact (or lowest negative impact) on the project.

Step 4: Set up a plan to monitor risks. The higher the probability of the occurrence of a risk event and the closer the time frame for the possible risk event, the greater the need to monitor for that event and communicate with the project team and stakeholders.

Some suggested tools for planning for, monitoring, and mitigating risks are:

- probability-impact matrixes (see Table A);
- decision trees or matrixes and probability trees, to quantify risk probabilities;
- three-point planning (best scenario, most likely scenario, worst scenario);
- statistical analysis: Target for the mean plus 1 standard deviation;
- assignment of utilities (the perceived value of a potential event): This type of analysis can help you decide whether to take a risk. The greater the potential gain, the more likely you are to accept the risk;
- division of a large risk into smaller pieces that are easier to manage so you are in a better position to mitigate the situation.

TABLE A. **Probability-Impact Matrix**

High Probability 66%–99%	High – Low LATER RESPONSE	High – Moderate THIRD RESPONSE	High – High* FIRST RESPONSE
Moderate Probability 33%–65%	Moderate – Low LATER RESPONSE	Moderate – Moderate LATER RESPONSE	Moderate – High SECOND RESPONSE
Low Probability 1%–32%	Low – Low LATER RESPONSE	Low – Moderate LATER RESPONSE	Low – High SECOND RESPONSE
Relative Weight = Probability × Impact	Low Impact	Moderate Impact	High Impact

* A High – High event should be analyzed to determine if it is a "showstopper."

As Table A shows, events with the highest relative weight are addressed first, so a high-probability, high-impact event would get the first response. Risks with lesser relative weights are dealt with as time and money allow.

The criteria for assigning impact should be agreed upon within the organization because this is a highly subjective concept. Attempts should be made to make the quantification more specific.

Table B shows that when risks are relatively low and opportunities relatively high, an organization is generally wise to invest resources necessary to capitalize on the opportunity. When risks are high and opportunities are low, steps should be taken to actively avoid the event. Further study is generally required in more moderate circumstances to determine if steps can be taken to mitigate the risks or enhance the opportunities.

TABLE B. **Risk-Opportunity Decision Matrix**

High Risk 66%–99%	High – Low AVOID	High – Moderate STUDY FURTHER	High – High AVOID
Moderate Risk 33%–65%	Moderate – Low AVOID	Moderate – Moderate STUDY FURTHER	Moderate – High STUDY FURTHER
Low Risk 1%–32%	Low – Low IGNORE	Low – Moderate INVEST	Low – High INVEST
	Low Opportunity	**Moderate Opportunity**	**High Opportunity**

APPENDIX H. Guidelines for Setting Per Diem Rates

Staff and clients, such as training participants, often incur costs for meals and accommodations while traveling or away from home on official business. To achieve consistency, minimize the burdens on the traveler to track and report costs, and maintain ease of accounting, many organizations opt to set a rate for meals and lodging.

Commonly, the traveler receives a flat allowance to cover meals and does not have to present receipts for the actual meals purchased. Lodging is often reimbursed on an actual basis, pending submission of a receipt from the hotel. To contain costs and prevent abuse, a maximum rate is generally established.

The rates are generally based on actual costs likely to be incurred in a given area. Depending on the size and diversity of the travel area, multiple rates may be established, generally by the city, region, or country where the travel occurs.

Below are some additional requirements and guidelines for establishing local per diem rates.

STEPS TO TAKE BEFORE SETTING LOCAL RATES

- Consult with the donor about any required local rates in effect.
- The Ministry of Health or local tax authority might have local per diem rates that can serve as guidelines.
  - Be careful of schemes that would be deemed salary enhancements rather than appropriate to cover actual costs of business travel.
- Survey similar organizations or collaborators regarding the rates they use and set a similar rate.
- Set independent rates, based on surveys of actual costs in areas where business travel occurs. Travelers or country office managers should survey the costs to obtain acceptable meals in a given area. Meals should be provided by restaurants or hotels that meet standards for cleanliness and any religious or dietary needs and preferences of local staff. The meals should not be lavish. In addition to a rate to cover meals, an additional 20 percent should be added to the rate to cover the incidental expenses of travelers.

SETTING PER DIEM RATES FOR WORKSHOP PARTICIPANTS

To eliminate many administrative burdens and risks related to payments of per diem rates to workshop/training participants, many organizations opt to provide full board (and lodging if appropriate) for workshop participants. Although not all participants may appreciate eliminating cash payments, this approach provides several benefits to the project:

- Costs can be controlled through package rates negotiated with hotels.
- There is no need to carry large sums of cash, collect receipts, and process the paperwork required to document per diem payments.
- Participants do not have to leave the venue in search of meals or to cash per diem checks.
- Communal dining provides networking and learning opportunities.

USING PREFERRED HOTELS

A preferred hotel is a hotel selected by the organization to provide lodging for all staff and consultants working in a specific area or for visitors providing technical assistance to the field office itself. Creating a list of preferred hotels allows the organization to control costs by negotiating favorable rates with hotels. It also simplifies the routine travel process because it is not necessary to search for hotels within per diem limits for individual trips.

Pledging substantial business to a hotel often makes it possible to obtain other needed services for free or at a reduced rate. This also provides cost savings for projects. These services might include:

- free or low cost Internet and business center services;
- discounts on conference room rentals;
- free airport transfers.

Selecting hotels in convenient locations, such as within walking distance of the office or counterparts, can eliminate the cost and inconvenience of obtaining ground transportation.

It is often practical to select more than one preferred hotel in a location, either to serve as a backup if the first choice has no vacancies or for different business purposes. For example, one hotel might be a preferred choice as a workshop venue and another as a location for travelers on out-of-town assignments.

CRITERIA FOR SELECTING HOTELS

Below are some criteria for selecting preferred hotels:

- clean rooms, bedding, and restaurants
- secure environment (the neighborhood as well as the building itself)
- air conditioning, fans, or heat, as appropriate
- location near work assignments
- meals available in the hotel or nearby restaurants
- availability of required business services, especially Internet access and telephone service

The choice of hotels is often subjective. It is important that staff feel comfortable, secure, and able to be productive in their environment. It is strongly suggested that frequent travelers be part of the selection committee for establishing the list of preferred hotels.

FULL BOARD LODGING

In some locations, the best lodging choice is a guest house that also includes meals in the rate. In this case, travelers are still entitled to a per diem allowance to cover incidentals only.

UPDATING MEAL ALLOWANCES AND HOTEL CHOICES

Inflation may cause costs to rise. New hotels may appear on the scene and selected hotels may no longer provide the quality or services expected. It is essential that there be a means of feedback for travelers to report rising costs or changes in the quality of hotels.

International rates may change as frequently as monthly. This frequency is not normally necessary at the local level, but routine reviews every six months are reasonable. Sudden or dramatic changes in circumstances may also trigger ad hoc reviews of rates or hotel selections.

APPENDIX I. Policy and Procedure Template

The notes below will assist you with understanding what should be included in each section.

1. **Topic** (Insert the name only of the process or activity.)

Policy or Procedure Name (Provide a unique number to make future updates easier. Document any dates, revisions, and approval of the board or management.)	Document No.	
	Effective Date	
	Revision Date	
	Revision No.	
	Approval	

2. **Purpose** (Insert a brief sentence or two that describe the policy or process.)

3. **Revision History**

Date	
Revision No.	
Change	
Ref. Section	

4. **People Affected** (Identify the various positions—not individuals' names—that are involved in the process being documented. This should include all roles that are involved, from the initiation to the conclusion of the process.)

5. **Applicable Policies** (Detail any rules, organizational or donor restrictions, or policies that apply to this procedure.)

6. **Definitions** (Define any terms or acronyms used in this document that might not be understood by all staff.)

7. **Procedure** (Carefully outline each phase and procedural step from initiation to completion, ensuring that they are logical and efficient.)

8. **Responsibilities** (Outline the roles played by the various positions affected. Do they involve requests, approvals, implementation, documentation, etc.?)

9. **Reference Materials** (Attach any forms, templates, tools, samples, or additional materials that document or support the process.)