FINANCIAL MANAGEMENT HANDBOOK

Pakistan Centre for Philanthropy

Prepared by Pakistan Centre for Philanthropy

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1. Introduction to Financial Management

a) Financial Management

Financial management involves planning, organizing, controlling and monitoring the finances of the organization. The funding sources for NGOs are decreasing and financial management is important to ensure that NGOs are:

- considered by donors as eligible to receive funds
- able to plan the use of funds effectively while keeping in mind any risks
- able to use the funds properly to achieve objectives
- able to act on a timely basis to avoid misuse or under/over expenditure of funds
- able to report back on the usage of funds

b) Building blocks of financial management

i. **Accounting records**

The organization needs to keep an accurate record of financial transactions to show when and how much funds were received and how they were spent.

ii. **Financial Planning**

The organization needs to plan how, where and when the funds will be used and what objectives will be achieved by the use of the funds. Planning is basic to the management process and involves looking ahead to prepare as well as possible for the future. For donor funds, this plan is shared with the donor, negotiated and approved by the donor and therefore needs to be followed to avoid risk of disallowances.

Planning tools an organization can use include Strategic plan, business plan, activity plan, budgets, work plans, cashflow forecast, feasibility study, etc.

iii. **Organizing**

The resources of the organization like staff and volunteers, vehicles, property and funds etc., need to be managed and coordinated to ensure implementation of the plans. It needs to be made clear that who will do what task, and when to achieve the objectives set in the plan.

Tools like organization chart, job descriptions, flow diagrams, finance manuals and budgets etc. help with better organizing.

iv. **Financial monitoring**

The organization needs to keep an eye on the fact that the funds are being utilized as per the initial plan. This involves producing regular and timely information for managers and stakeholders for monitoring purposes. Monitoring involves comparing actual performance with plans to evaluate the effectiveness of plans, identify weaknesses early on and take corrective action if required.

Evaluation reports, budget monitoring reports, cashflow reports, financial statements, project reports, donor reports, audit reports, evaluation reports, etc. can be used by an organization for effective monitoring.

v. **Internal controls**

The organization needs to have controls in place to protect its assets, any misappropriation/ misuse of funds. The purpose is to avoid any theft or fraud, and detect errors and omissions in accounting. A system of controls, checks and balances are essential to ensure proper application of procedures and resources during programme implementation.

Tools like budgets, delegated authority, procurement procedure, reconciliation, fixed asset register, and standard operating procedures should be used by the organization to build effective internal controls.

c) Management of loan recoveries

Loan recovery is the process of seeking money that is owed to an organization. The organization may take a number of steps to ensure that the debt is paid back to the organization and that too on a timely basis.

- Pre-screen debtors before extending loan
- Keep careful track of exactly what is owed and when was the loan extended?
- Ensure that the debtor clearly understands payment terms (and penalties) upfront
- Offer incentives for paying instantly or for paying early
- Get everything in writing (and signed) when you extend a loan
- Reach out to borrowers both before the money becomes due and when the debt must be paid
- Provide options for repayment
- Record all attempts to collect

2. FINANCIAL & PROCUREMENT POLICIES

A policy sets out a set of principles and guidelines for a key area of activity within an organization. Once approved, a policy is binding on everyone in the organization and failure to do so could result in disciplinary action

a) Purpose of financial and procurement policies

Financial and procurement policies dictate:

- ✓ which job roles are allowed to authorize various activities within the organization
- ✓ bank accounts' opening and management
- ✓ new suppliers and how to choose them
- ✓ buying and purchasing – for example, how to determine when purchasing needs to be initiated and how
- ✓ debt collection
- ✓ risk management

b) What makes a good policy?

- ✓ It is fair and realistic
- ✓ It covers all situations likely to arise
- ✓ It meets legal requirements
- ✓ It is affordable for the organization

c) Developing Financial Policies

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

Here are some ideas for you to consider:

Decide who will be involved in drawing up the policy
If the policy is to have an impact on how programmes are delivered, it makes sense to include programme staff in the discussions.

Do some background research to gather the information you need to develop the policy
For example, if you were setting a policy on health-care support for staff, ask around other
NGOs to see what they offer and what it costs.

Write the policy document
Use the following headings as a guide:

- The purpose of the policy
- Why we need the policy
- Who the policy applies to
- The policy guidelines

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

d) Implementation of financial and procurement policies

Implementation of policies helps to:

- ✓ Avoid duplication of work as every employee is clear about his/her role
- ✓ Avoid in-subordination as every employee is aware of the authorization requirements
- ✓ Manage bank accounts and its transactions effectively lowering risk of fraud and misappropriations
- ✓ Ensure that the procurement is done only when required, at the right cost and of the best possible quality- hence value for money
- ✓ Take appropriate steps to recover loans on time from the debtors
- ✓ Identify and manage financial and compliance risks of the organization

For effective implementation of the policies, these should be communicated to all concerned employees, interactive sessions held with them to explain the rationale behind the policies and the repercussions of not following them. The policies should be followed by procedures which describe the steps for carrying out the guidelines in the policy. These often require completion of forms to gather data and authorization for actions.

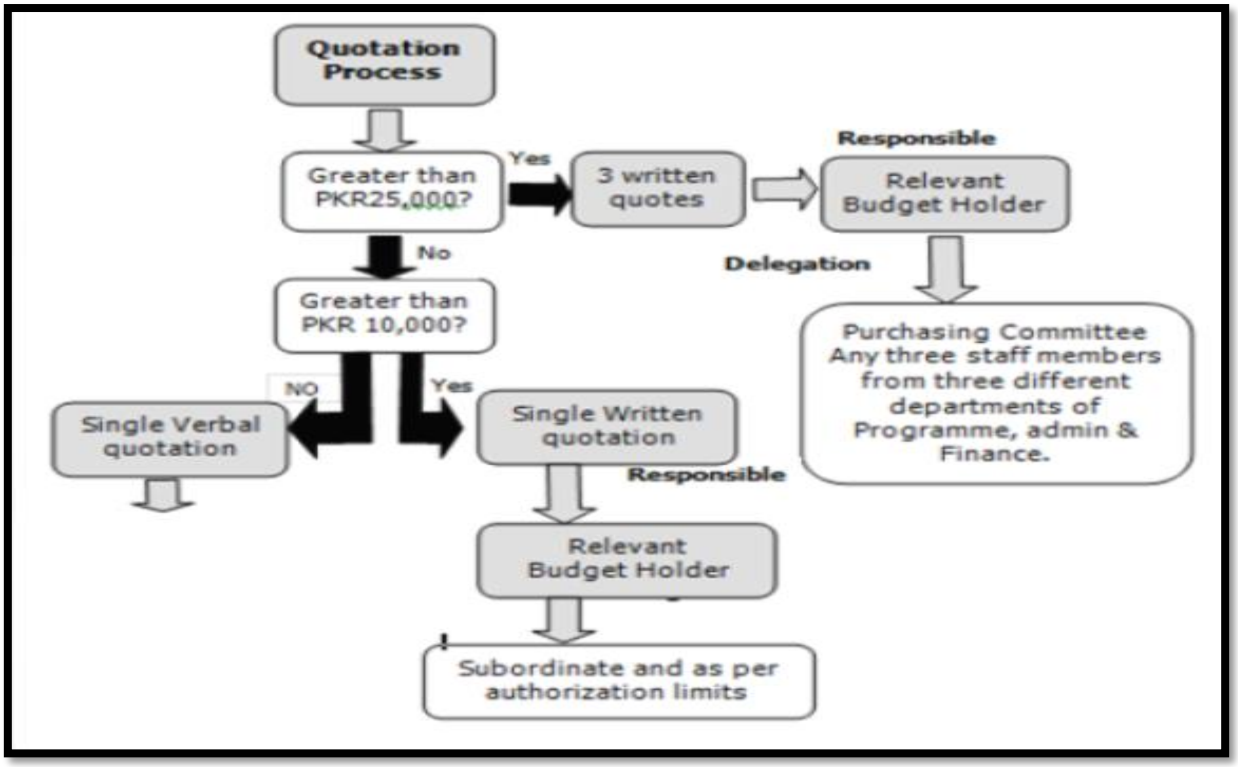
Procurement policies should clearly stipulate the financial limits for single source, selective and open tendering with details on all three kinds of procurements the announcement requirements. Every step of the procurement process should be clearly documented to ensure transparency. It must be ensured that funds have been allocated and approved for all the procurements that are to take place. Authorization requirements for initiating and finalizing the procurement process should also be set clearly to avoid any confusions.

HANDOUT:
A sample procurement policy will be circulated with all the participants to help them understand and implement a basic procurement mechanism

e) Steps of procurement process

- Identifying the need
- Specifying the need
- Request for Approval
- Invitation to Quotation/Sourcing potential suppliers or service providers
- Collect the Quotation from vendor
- Obtaining prices that are competitive
- Formation of a Purchasing Committee
- Evaluating proposals from potential suppliers or service providers/ Quotation Analysis
- Placing orders/ Local Purchase Order
- Good receive Note
- Making payment

f) Illustration of Procurement Process



g) Finance Manual

The Finance Manual brings the financial policies and procedures all together in one document.

What goes in a Finance Manual?

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

The manual may also include some reference materials such as
_ Organization Chart
_ Job Descriptions
_ Standard forms

3. Bank Management

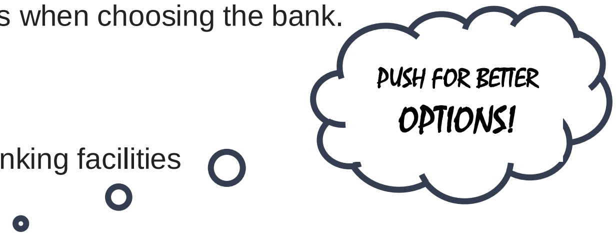
a) Why open a bank account?

To safeguard the monies received and to operate transparently, an NPO is required to open an account with the scheduled bank. As per the Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) Guidelines, and Associations with Charitable and Not for Profit Objects Regulations 2018 issues by Securities & Exchanges Commission of Pakistan, NPO must receive all donations and funds through banking channel and which must be in conformity with the books of accounts of NPO.

b) How to choose the right bank?

Choosing the right bank, negotiating with bank managers, and shopping around for the best rates and services are all important steps when choosing the bank.

- Areas of operations
- Free Services offered
- Availability of Self Service facilities
- Associated benefits with employee banking facilities
- Interest rates
- Bank Charges
- Investment options for free laying funds



c) What to determine before opening a bank account?

It is always advisable to work out the banking arrangements before-hand. Below mentioned decisions should be sought in writing from the competitive authority (Board of Directors or Trustees):

- Number of bank accounts
- Number of signatories
- Authorization levels
- Procedure and authorizations required to alter manner of bank operations

d) Get Registered

To open a bank account, an NPO must first get itself registered and provide a certified true copy of the registration document to the bank. In Pakistan, there are a number of laws for registration of an NPO, including the following prominent laws:

- The Societies Registrations Act, 1860
- The Trust Act, 1882
- The Voluntary Social Welfare Agencies (Registration & Control Ordinance), 1961.
- The Companies Act 2017

e) Authorization matrix

An authority matrix is a list or table that sets out who can approve a change, subject to cost limits, or areas of responsibility. The documentation of the company's authority matrix is essential to the internal control within all businesses as it defines the financial and administrative responsibilities and authorities delegated to those in charge of approving the decisions and transactions within the business. A clearly defined hierarchy creates a path of accountability for every project and activity within the company. A hierarchy helps to establish efficient communication paths between employees, departments and divisions of the company.

EXAMPLE:

Financial Approval Limits

Personnel authorized to approve procurement of goods expenditure are:

Value of Purchase	Approval Required from
Up to Rs. 250,000	Head of F&A
Up to Rs. 1,000,000	Executive Director
Above Rs. 1,000,000	Chairperson BoD

f) State Bank of Pakistan Directives

To minimize the risk of money laundering & terrorist financing activities, the State Bank of Pakistan has instructed the banks to enhance the due diligence while establishing relationship with the NPOs. Some of the key due diligences required by the banks are as follows:-

- The account(s) must be opened only in the name of the NPO as per the title mentioned in the registration document.
- The authorized person(s) and the governing body are also subject to comprehensive due diligence. The banks are to ensure that these persons are not affiliated with any proscribed entity.
- An NPO must not be allowed to use personal bank accounts for publically calling for collection of donations / charity.

g) TIPS for opening bank account

- It is always better to get the set of draft documents vetted by the Bank's legal department before sending out to authorized person(s) for signatures to avoid amendments at a later stage
- It is advisable to add one or two authorized person(s) as backup to ensure smooth functioning of bank account in case of non-availability of any authorized person.
- Most of the authorized person(s) should belong to city of entity's operations to enable timely approval of transactions.
- All CNIC copies should be checked for expiry dates to ensure any future issues.

h) Bank Reconciliation

A bank reconciliation is the process of matching the balances in an organization's accounting records for an account to the corresponding information on a bank statement. The goal of this process is to ascertain the differences between the two, and to book changes to the accounting records as appropriate. The information on the bank statement is the bank's record of all transactions impacting the entity's bank account during the past month.

A bank reconciliation should be completed at regular intervals for all bank accounts, to ensure that a organization's records are correct. Otherwise, it may be found that balances are much lower than expected. A bank reconciliation will also detect some types of fraud after the fact; this information can be used to design better controls over the receipt and payment of cash. At a minimum, conduct a bank reconciliation shortly after the end of each month, when the bank sends the bank statement containing the bank's beginning balance, transactions during the month, and ending balance

Bank Reconciliation Process Flow

The essential process flow for a bank reconciliation is to start with the bank's ending balance, add to it any deposits in transit from the company to the bank, subtract any checks that have not yet cleared the bank. Then, go to the company's ending balance and deduct from it any bank service fees, any other penalties and charges, and add to it any interest earned. At the end of this process, the adjusted bank balance should equal the company's ending adjusted cash balance.

Problems with Bank Reconciliations

Uncleared checks that continue to not be presented. There will be a residual number of checks that either are not presented to the bank for payment for a long time, or which are never presented for payment. In this case, you should contact the payee to see if they ever received the check; you will likely need to void the old check and issue them a new one.

Deposited checks are returned. There are cases where the bank will refuse to deposit a check. In this case, you must reverse the original entry related to that deposit, which will be a credit to the cash account to reduce the cash balance, with a corresponding debit (increase) in the accounts receivable account.

4. Methods of Accounting

Good financial records are the basis for sound financial management of your organization. All organizations need to keep records of their financial transactions so that they can access information about their financial position. NGOs especially need to be seen to be scrupulous in their handling of money – keeping accurate financial records promotes integrity, accountability and transparency and avoids suspicion of dishonesty. There is often a statutory obligation to keep and publish accounts and donor agencies almost always require audited accounts as a condition of grant aid.

a) Accounting Methods

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

There are two main methods for keeping accounts:

- ✓ Cash Accounting
- ✓ Accrual Accounting

Cash Accounting

This is the simplest way to keep accounting records and does not require advanced bookkeeping skills to maintain.

The main features are:

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

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

Accruals Accounting

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

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

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

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

Example of an Accrual

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

b) Types of Accounts

There are five basic types of accounts:

Asset accounts, which record all the resources your organization owns (like inventory and property) Assets are things that a company owns that have value. This typically means they can either be sold or used by the company to make products or provide services that can be sold. Assets include physical property, such as plants, vehicles, equipment and inventory. It also includes things that can't be touched but nevertheless exist and have value, such as trademarks and patents. And cash itself is an asset. So are investments a company makes. Assets are generally listed based on how quickly they will be converted into cash. Current assets are things a company expects to convert to cash within one year. Noncurrent assets are things a company does not expect to convert to cash within one year or that would take longer than one year to sell. Noncurrent assets include fixed assets. Fixed assets are those assets used to operate the business but that are not available for sale, such as vehicles, office furniture and other property.

Liability accounts, which record all the obligations and debts you owe (like monthly rent payments payable). Liabilities are amounts of money that a company owes to others. This can include all kinds of obligations, like money borrowed from a bank to launch a new product, rent for use of a building, money owed to suppliers for materials, payroll a company owes to its employees, environmental cleanup costs, or taxes owed to the government. Liabilities also include obligations to provide goods or services to customers in the future. Liabilities are generally listed based on their due dates. Liabilities are said to be either current or long-term. Current liabilities are obligations a company expects to pay off within the year. Long-term liabilities are obligations due more than one year away.

Revenue or income accounts, which record the money that comes into your organization (like grant or donation etc.)

Expense or expenditure accounts, which record all the cash that flows out from your organization (like employee salaries or monthly utility payments)

Equity accounts, which record an organization owner's held interest in the organization (like stock shares). Shareholders' equity is sometimes called capital or net worth. It's the money that would be left if a company sold all of its assets and paid off all of its liabilities. This leftover money belongs to the shareholders, or the owners, of the company.

c) Rules of Accounting

	Assets	Liabilities	Fund/Reserves	Income	Expense
Normal Balance	Debit	Credit	Credit	Credit	Debit
When balance to Increase	Debit	Credit	Credit	Credit	Debit
When balance to Decrease	Credit	Debit	Debit	Debit	Credit

d) Financial Accounting vs. Management Accounting

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

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

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

- the expertise and resources available;
- the volume and type of transactions;
- reporting requirements of managers;

- obligations to donors; and
- the communities NGOs work with.

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

Management Accounting

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

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

e) Chart of Accounts

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

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

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

When a transaction takes place, it is recorded in the books of account and categorized according to the guidance held in the Chart of Accounts.

Each organization's Chart of Accounts will be different. Typically, the layout will include account code, account name, the type of financial statement it will hit (income statement or balance sheet), the type of account and the functional area.

Account Code	Account name	Financial Statement	Type	Functional Area (Group)
1001	Bank Account	Balance Sheet	Asset	Cash
1002	Cash in Hand	Balance Sheet	Asset	Cash
1201	Accounts receivable	Balance Sheet	Asset	Receivable
1202	Grants receivable	Balance Sheet	Asset	Receivable
1301	Prepaid Expenses	Balance Sheet	Asset	Prepayments
1401	Accrued Revenue	Balance Sheet	Asset	Accruals
1501	Equipment	Balance Sheet	Asset	Fixed Assets
1502	Accumulated Depreciation	Balance Sheet	Asset	Fixed Assets
2001	Accounts payable	Balance Sheet	Liability	Payable
2002	Accrued Expenses	Balance Sheet	Liability	Accrued Liabilities
3001	General Fund	Balance Sheet	Equity	Funds
4001	Contributions	Income Statement	Income	Receipts
4002	Donations	Income Statement	Income	Receipts
4003	Grants	Income Statement	Income	Receipts
5001	Rent	Income Statement	Expense	Operational Expense
5002	Supplies	Income Statement	Expense	Operational Expense
5003	Travel	Income Statement	Expense	Program Expense
5004	Salaries	Income Statement	Expense	Payroll expense

f) Cost Centres

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

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

The starting point for deciding on a cost centre structure is the organization chart and donor funding agreements. There is no effective limit on the computer accounting program is used. However, it is important to design the cost centre structure carefully to prevent record keeping become burdensome and counter-productive. Each cost centre is given a unique reference or code to identify it within the records.

How are cost centres used

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

‘*Which budget line item does this belong to?’*

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

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

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

g) Types of Costs

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

Direct costs are those which are clearly related to a particular activity and can be charged directly to the relevant Cost Centre. For example, in a training project, the costs of room hire for a training event and the trainer's salary.

Indirect costs are those which are of a more general nature and relate to the organization as a whole or more than one activity. For example, head office rent, the audit fee and the Chief Executive's salary. These usually form the bulk of what are known as overhead or central administration costs.

5. Financial & Accounting records

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

Accounting records are all of the documentation and books involved in the preparation of financial statements or records relevant to audits and financial reviews. Accounting records are key sources of information and evidence used to prepare, verify and/or audit the financial statements. They also include documentation to prove asset ownership for creation of liabilities and proof of monetary and non-monetary transactions. Accounting records are the original source documents, journal entries, and ledgers that describe the accounting transactions of a business. Accounting records support the production of financial statements.

Accounting records fall into two main categories:

- Supporting Documents
- Books of Accounts

a) Supporting documents

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

- Receipt voucher for money received
- Payment voucher for money paid out
- Invoices – certified and stamped as paid
- Bank statements
- Journal vouchers – for one-off adjustments and non-cash transactions.

With these documents on file it will always be possible to construct a set of accounts. Other useful supporting documents include Purchase Orders and Goods Received Notes.

b) Books of account

Bookkeeping begins with setting up each necessary account so you can record transactions in the appropriate categories. It must be kept in mind that a proper record should be maintained for each transaction which is also known as the audit trail. The audit trail basically should tell the entire story of a transaction, from the initiation, validation, approvals to payment/receipt. Be organized. Make sure that all documents are properly filed, and all procedures properly followed.

The minimum requirements for books of account are:

- Bank book for each bank account
- Petty cash book
- Journal
- General Ledger

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

- Payroll record
- Assets Register
- Stock Control Book

Bank Book
The Bank Book is the main book of account for recording bank transactions (i.e. 'cash' transactions). It is normal to maintain a separate Bank Book for each bank account held as this makes it easier to reconcile each account at the end of the month.

Petty Cash Book
Petty cash book records day-to-day cash receipts and payments. Usually the cash receipt is the money that is paid into petty cash to top up the float (a pre-set amount say Rs.25,000/-).

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

General Ledgers
This is a central record which pulls together basic bookkeeping information from the main working books of account. It plays a central role in the double-entry bookkeeping system and is the basis for the Trial Balance, the starting point for preparation of financial statements.

A general ledger is typically used by organizations that employ the double-entry bookkeeping method - where each financial transaction is posted twice, both as debit and a credit and where each account has two columns. Because a debit in one account is offset by a credit in a different account, the sum of all debits will be equal to the sum of all credits.

c) Cash advances

Cash advances are often paid to the employees by the organization to cover organization expenses which will be incurred by the employees on the organization's behalf. These are often paid when employees are expected to incur the expenses away from the organization (for e.g. on official travel).

For the finance unit to process such advances, the advance needs to be approved by the competent authority as stipulated in the financial policies and procedures. The advance must be settled once the employee is back in office. The employee must report back on the expenses made against the advance, with sufficient and adequate supporting documents. Based on the actual verifiable expenditure, the advance must be settled by the finance unit by either receiving from the employee and depositing the unspent advance back in the bank or paying the over-spent against the advance to the employee.

d) Record of donors, beneficiaries and funds received

Donors:

Record of donors:

Any LSO or CSO receiving funds and/or donations are to keep appropriate record of all the funds received. The details include information about donor's names, addresses, type of donation received i.e in cash or in kind, amount/value of donation received, date of receipt of donation, mode of payment, particulars of payment instrument and the purpose of donation.

Know your donors

- Before receiving funds from a donor, LSOs/CSOs must establish that the donor is not placed on the United Nations' list of persons who are linked to terrorist financing or against whom a ban, sanction or embargo subsists.
- LSOs/CSOs shall undertake best efforts to document the identity of donors and purpose of donations
- LSOs/CSOs shall conduct, on a risk-based approach, a reasonable search of public information, including information available on the Internet, to determine whether the donor or their key employees, board members or other senior managerial staff are suspected of being involved in activities relating to terrorism, including terrorist financing.

Beneficiaries

Record of Beneficiaries

A register of donee/ beneficiaries is also to be maintained including information about their names, addresses, type of disbursement i.e. in cash or in kind, amount/value of disbursement, date of disbursement and the purpose and other details of disbursement.

Know Your Beneficiaries and Partners

- LSOs/CSOs must ascertain correct and complete identification particulars of each of its beneficiary (person, group of persons or organization etc.) who receives cash or services or in-kind contributions.
- In case the beneficiary is an organization/ group of persons, the donor/intermediary LSO/CSO must have knowledge of detailed profile and particulars of such organization. LSO/CSO shall ensure that its beneficiaries are not linked with any suspected terrorism activity or any link with terrorist support networks.
- In case where the projects are implemented through partnership agreements with other partners, the LSO/CSO shall make it a part of its project agreements that partners shall maintain and share beneficiaries' information.
- LSO/CSOs must ensure that the partner organizations shall not be from any such organization whose license has been revoked by SECP or registration cancelled by other authorities.

QUESTION

A person visits your organization expressing intent to donate Rs.100,000/- in cash for the benefit of a pre-identified family from a near-by area. How should the finance person from the organization respond?

6. Financial Reporting

One of the main reasons for keeping accounting records is so that information about how the organization is being run can be obtained. Financial reports are needed primarily by those responsible for managing the organization and by current and potential donor agencies; but those responsible for financial management of an NGO also need to 'give an account' of their stewardship to a wide range of stakeholders.

a) Trial Balance

At the end of an accounting period, all the accounts categories having a balance in the General Ledger are listed on a summary sheet to form a Trial Balance. The Trial Balance is simply an arithmetical check on the accounts maintained using the Double Entry method of accounting. It is also the basis for the preparation of accruals-based financial statements.

b) Financial Statements

Financial statements are a product of the financial accounting process. They are a summary of all the transactions for a specified period and show the financial position of an organization. Financial statements can cover any period of time – for example, a month, a quarter or one year. The annual financial statements are used as the basis for an annual external audit.

There are mainly five components of a financial statements:

1- Balance Sheet
2- Income Statement
3- Cash Flow Statement
4- Statement of Changes in Equity
5- Notes to Financial Statements

1. Balance Sheet

A balance sheet provides detailed information about a company's assets, liabilities and equity.

A company's assets have to equal, or "balance," the sum of its liabilities and shareholders' equity/reserves. Balance sheets show assets at the top, followed by liabilities, with shareholders' equity at the bottom. It shows a snapshot of a company's assets, liabilities and shareholders' equity at the end of the reporting period. It does not show the flows into and out of the accounts during the period.

Balance sheets allow the user to get an at-a-glance view of the assets and liabilities of the company. The balance sheet can help users answer questions such as whether the company has a positive net worth, whether it has enough cash and short-term assets to cover its obligations, and whether the company is highly indebted relative to its peers. There are a number of steps to follow to prepare a balance sheet. The recommended approach to doing so is noted in the following steps:

- construct the trial balance by transferring the ending balance in every general ledger account to a spreadsheet.
- adjust the preliminary trial balance to ensure that the balance sheet follows the relevant accounting framework. Each adjusting entry should be thoroughly documented, so that auditors can determine why it was made.
- Eliminate from the trial balance all accounts except those for assets, liabilities, and equity
- The line items in the balance sheet are usually far fewer than the line items in the trial balance, so aggregate the trial balance line items into the ones used in the balance sheet.
- Verify that the total for all assets shown in the balance sheet equals the total for all liability and stockholders' equity accounts.
- Re-write the resulting balance sheet into the format required for presentation

2. Income Statement

An income statement is a financial statement that shows you the company's income and expenditures. It also shows whether a company is making profit or loss for a given period. The income statement, along with balance sheet and cash flow statement, helps you understand the financial health of your business. The profit or loss is determined by taking all revenues and subtracting all expenses from it.

- construct the trial balance by transferring the ending balance in every general ledger account to a spreadsheet.
- Aggregate all of the revenue line items on the trial balance and insert the result into the revenue line item in the income statement.
- Aggregate all of the expense line items \in the trial balance, and insert the result into the program, general and administrative expenses line item in the income statement.
- Calculate the surplus/deficit before tax by deducting the total expense from the income
- Multiply the applicable tax rate by the surplus/deficit before tax to arrive at the income tax expense.
- Subtract the income tax from the surplus/deficit before tax figure to arrive at the surplus/deficit after tax figure
- This will increase/decrease the opening reserves balance as shown in the balance sheet of the organization

3. Cashflow Statement

A cash flow statement shows how changes in balance sheet and income statement affects cash and cash equivalents, and breaks the analysis down to operating, investing, and financing activities. Since the cash flow statement provides insight into different areas a business used or received cash, it’s an important financial statement when it comes to valuing a company and understanding how it operates.

The first step in preparing a cash flow statement is determining the starting balance of cash and cash equivalents at the beginning of the reporting period. The direct method of calculating cash flow from operating activities is straightforward and involves taking all the cash collections from operations and subtracting all the cash disbursements from operations. This approach lists all the transactions that resulted in cash paid or received during the reporting period.

After calculating cash flow from operating activities, you need to calculate cash flow from investing activities. This section of the cash flow statement details cash flows related to the buying and selling of long-lived assets like property, facilities, and equipment. Keep in mind that this section only includes investing activities involving free cash, not debt.

The third step of the preparation of cash flow statement covers cash inflows and outflows related to financing activities. This includes cash flows from both debt and equity financing; in other words, cash flows associated with raising cash and paying back debts to investors and creditors. Finally, once cash flows from the three main types of business activities are accounted for, you can determine the ending balance of cash and cash equivalents at the close of the reporting period.

The change in net cash for the period is equal to the sum of cash flows from operating, investing, and financing activities. This value shows the total amount of cash a company gained or lost during the reporting period. A positive net cash flow indicates a company had more cash flowing into it than out of it, while a negative net cash flow indicates it spent more than it earned.

4. **Statement of Changes in Equity**

The statement of changes in equity is a reconciliation of the beginning and ending balances in a company's equity during a reporting period. The statement starts with the beginning equity balance, and then adds or subtracts such items as profits to arrive at the ending balance

To prepare the statement, follow these steps:

I. Create separate accounts in the general ledger for each type of equity. Thus, there are different accounts for different types of funds and retained earnings. Each of these accounts is represented by a separate column in the statement.
II. Transfer every transaction within each equity account to a spreadsheet, and identify it in the spreadsheet.
III. Aggregate the transactions within the spreadsheet into similar types, and transfer them to separate line items in the statement of changes in equity.
IV. Complete the statement, and verify that the beginning and ending balances in it match the general ledger, and that the aggregated line items within it add up to the ending balances for all columns.

5. **Notes to Financial Statements**

Notes to the financial statements disclose the detailed assumptions made by accountants when preparing a company's: income statement, balance sheet, statement of changes of financial position or statement of retained earnings. The notes are essential to fully understanding these documents.

c) Donor report

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

Where there are several donors it is important to set up the accounting systems so that the information required by the donor agency can be easily retrieved. Otherwise the organization will be involved in a tedious information gathering exercise every time a report is required. The use of Cost Centres is particularly useful here.

When putting together a report to donors do:

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

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

d) Budget variance report

Budget is an estimation of cost involved in performing activities of the targeted results to achieve the goals and objectives of the entire program, in a specific time frame. In other words it is a financial plan for a project that expresses cost of resources needed to implement activities in order to achieve an objective, and state their sources.

A budget variance report is a document that compares planned financial outcomes with the actual financial outcome. In other words: a variance report compares what was supposed to happen with what happened. Usually, variance reports are used to analyze the difference between budgets and actual performance.

How to write a variance report:

To write a variance report, you must complete the following steps:

- Collect and organize the data you wish to analyze in a spreadsheet. This could mean: budget data for a given time period in one column vs. actual data from the same time period in another column.
- Determine the variance in separate columns. You can choose to express variance as a financial figure and then again as a percent.
- Explain the variance. You must explain what occurred to cause the variance, whether positive or negative. Best practices dictate that you should use unemotional language and be short and concise. Indicate the variance you're speaking about. Then describe the cause of the variance. Finally, outline potential or actual effect on your organization.

7. Financial Audit

An audit is an independent examination of records, procedures and activities of an organization, resulting in a report on the findings. Audits are important for NGOs as they demonstrate a commitment to transparency and accountability and bring credibility to the NGO.

a) External Audit

An external audit is an independent examination of the financial statements prepared by the organization. It is usually conducted for statutory purposes (because the law requires it). The purpose of external audit is to verify that the annual accounts provide a true and fair picture of the organization's finances; and that the use of funds is in accordance with the aims and objects as outlined in the constitution.

b) External audit process and its conclusion

- Initiation meeting
- Completion of the Audit requisition check-list
- Communicating the audit sample to relevant staff
- Audit conclusion meeting and Management/BOD Letter
- Audit Report
- Audit Committee Meeting/BOD meeting
- Annual General Meeting

c) Engagement of Auditors

- Choose three or four external audit firms
- Introduce your organization, its legal status, period of accounts, reason for audit and ask them for technical and financial proposals. It is very important that the audit team is able to speak the same language as your accountant. It should be made part of the request for proposal.
- Review each proposal thoroughly, especially the scope of services and the estimated fee chart (double check what is included in fee and what they will charge out of pocket)
- You want to find the most qualified firm for the job at a cost that fits with your company's budget and in the timeframe required. Cost, sector experience, office locations and many other factors may be more important considerations for your company than size and name recognition.
- Based on your findings, make a recommendation to the BOD. Legally, the company's BOD is required to hire auditors within ninety days of the date of incorporation of the company

d) Preparation of financial audit

- Check which financial standards are applicable on your organization's financial statements (depends on annual gross revenue
- ; Rs.200m or above- IFRS, Below Rs.200m- Accounting Standards of NPOs)
- Allocate a focal person for the audit (someone from the organization who has prepared the financial statements)
- Be prepared with:
  - Policy and procedures documents including approval matrix etc.
  - financial statements,
  - accounting records, and
  - supporting documents for all financial transactions (ensure there is a paper trail in place to show that the policies have been followed and the flow of funds can be confirmed)
  - Everyone in your company should know that the audit is taking place, including senior management and stakeholders

▪ **An Auditor's Checklist**

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

e) Audit Report

An audit results in a report addressed to members which gives an 'audit opinion' as to the 'true and fair' view given by the financial statements.

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

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

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

8. Legal Compliance

a) Non-Governmental Organization (NGO)

A non-governmental organization is an organization that generally is formed independent from government. They are typically nonprofit entities, and many of them are active in humanitarianism or the social sciences.

NGOs operate in a wide range of fields and come in all shapes and sizes. Whilst each one is unique, most share some common features:

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

b) Legal Status

There are a number of different ways of registering as an NGO and this will determine the organization’s legal status. The NGOs can be registered under the following laws:

I. Section 42 of Companies Act 2017
II. Section 11-Cooperative Societies Act 1925
III. Registered under Voluntary Social Welfare Agencies (Registration & Control) Ordinance, 1961
IV. Non-trading company formed under Section 5 of Companies Ordinance 1984
V. Chapter X-Local Government Ord KPK, 2001 (Citizen Community Board)

c) Constitution

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

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

d) The Governing Body

The governing body is legally responsible and accountable for governing and controlling the organization. This means that if anything goes wrong in the NGO then the law holds the members of the governing body responsible. It has many different names – Council, Board of Directors, Board of Trustees, Executive or Governing Board – and several functions including:

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

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

e) Legal Compliance Requirements

There are three types of compliances which an organization is obligatory to fulfil after its incorporation. These are (1) post incorporation, (2) annual compliances, and (3) or the eventual compliances i.e. on the happening of certain events.

Examples of Post Incorporation:

1. The number of directors and the names of the first directors and name of chief executive shall be determined (section 42)
2. Start functioning within three months of the date on which the certificate of registration is issued (Social Welfare)

Examples Annual compliance

1. Holding of Annual General Meeting
2. Present financial statements/Annual report

Examples of Eventual compliance

1. After election of directors, filing has to be done with SECP (Section 42)
2. Amendment in the constitution documents