HUMANITARIAN ACADEMY · HUMANITAIRES JOBS

Mini MBA Finance and Grants: managing donor money and financial health

Course handout · Week 9 : Measuring an organisation's financial health

A programme of exactly 3 months (12 weeks, 144 hours) to manage the finances of a humanitarian organisation and donor funds: NGO accounting and restricted funds, budgets and shared costs, cash and foreign exchange, budget monitoring and forecasts, eligibility rules, the grant cycle, partner funding, audits and fraud, financial health, full cost, reserves and diversification, governance and turnaround. Corrected numerical exercises, three monthly exams with case studies, and a verifiable diploma from the Humanitarian Academy.

https://humanitairejobs.org/en/academy/mini-mba-finance-subventions/semaine-9/

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Week 9 : Measuring an organisation's financial health

Objectives

- Calculate and interpret an NGO's key ratios: liquidity, months of reserves, dependency, overhead rate, shared cost coverage.
- Read an organisational financial dashboard and spot the signs of an approaching cash crisis.
- Explain why a low overhead rate is not an indicator of quality, and defend the true cost structure.

Why ratios?

An NGO's financial statements (balance sheet, income statement, cash flow statement) contain a lot of figures. **Ratios** make them comparable over time and between organisations, and allow the board, donors and auditors to ask the right questions quickly.

Three families of questions:

- **Can we pay our short-term debts?** Liquidity and cash.
- **Can we absorb a shock?** Unrestricted reserves, months of operation covered.
- **Is our model sustainable?** Dependency on donors, shared cost coverage, result on unrestricted funds.

An isolated ratio says nothing; a three-year trend and a comparison with similar organisations say a lot.

Liquidity and cash

Current ratio = current assets / current liabilities. Below 1, the organisation cannot, in theory, cover its short-term debts with its short-term assets.

Quick (cash) ratio = (cash + short-term investments) / current liabilities. It excludes receivables, which may be slow to come in.

Beware an NGO-specific feature: a large part of cash often consists of **donor advances** not yet spent, recorded as liabilities as deferred income (funds received to be returned or used). This cash does not freely belong to the organisation.

Example. Current assets 2,400,000 USD (including cash 1,500,000, receivables from donors 800,000, other 100,000). Current liabilities 2,000,000 USD (including unspent donor advances 1,300,000, suppliers and salaries 700,000). Current ratio = 2.4 / 2.0 = 1.2. Quick ratio = 1.5 / 2.0 = 0.75. "Free" cash = 1,500,000 − 1,300,000 = 200,000 USD, to be compared with the 700,000 USD of current liabilities excluding advances: the organisation depends on prompt payment of its 800,000 USD of receivables from donors.

Reserves and months of operation

Free reserves (or available unrestricted funds) are the share of funds that is neither restricted to a project, nor tied up in equipment, nor blocked by a board decision.

Months of reserves = free reserves / (total annual expenditure / 12). Some organisations use only overhead costs as the denominator, which gives a more flattering figure: the definition must always be stated.

Example. Funds 1,100,000 USD, of which 300,000 tied up in fixed assets (vehicles, buildings) and 200,000 designated by the board for an emergency fund. Free reserves = 600,000 USD. Annual expenditure 9,600,000 USD, i.e. 800,000 a month. Months of reserves = 600,000 / 800,000 = 0.75 months. On overhead costs alone (1,440,000 USD a year, i.e. 120,000 a month), the result is 5 months.

Common benchmarks aim for 3 to 6 months of overhead costs, but the right target depends on risk: frequent pre-financing, contracts in volatile currencies, end-of-contract indemnity obligations.

Dependency and income structure

A fragile organisation depends on few sources. Useful indicators:

- **Share of the largest donor** in total income. Above 40 to 50%, the loss of this donor threatens the organisation's existence.
- **Concentration index** (Herfindahl-Hirschman): the sum of the squares of each source's share. Close to 1 = a single source; close to 0 = highly diversified sources.
- **Share of unrestricted funds** in total income: these are the only funds that give strategic freedom.

Example. Income: donor A 50%, donor B 30%, donor C 10%, private donations 10%. HHI = 0.25 + 0.09 + 0.01 + 0.01 = 0.36. Another organisation with five sources of 20% each has an HHI of 5 × 0.04 = 0.20. The first is clearly more exposed.

> Diversifying does not mean multiplying small contracts: each contract has a management cost. The aim is to avoid a single external decision putting the organisation in jeopardy.

The myth of low overheads

The **overhead rate** (overheads / total expenditure) is often used by the public as a measure of efficiency. It is misleading. The nonprofit starvation cycle is well documented: donors expect low overheads, NGOs under-report their true costs, underinvest in systems, staff and security, and then weaken.

What matters is that overhead costs are **necessary, controlled and covered**. An organisation with 6% overheads that has no internal auditor, no reliable accounting system and no security manager is not more efficient: it transfers the risk to its teams and its beneficiaries.

Shared cost coverage rate = shared costs recovered from projects (indirect costs and budgeted shared costs) / actual shared costs. **Example:** actual costs of headquarters and country offices 1,440,000 USD; recovered 1,152,000 USD. Coverage = 80%; the shortfall of 288,000 USD must be covered by unrestricted funds, or it will consume the reserves.

The organisational financial dashboard

A dashboard presented to the board every quarter fits on one page. It combines:

Indicator	Value	Target	Trend
Months of reserves (overhead costs)	2.5	≥ 4	falling
Quick ratio	0.8	≥ 1	stable
Share of largest donor	47%	≤ 35%	rising
Shared cost coverage	86%	≥ 100%	rising
Donor receivables over 90 days	410,000 USD	< 150,000	rising
Result on unrestricted funds	−95,000 USD	≥ 0	falling

Reading: reserves are melting because shared costs are not fully covered and the unrestricted result is negative; at the same time, old receivables are squeezing cash. It is not yet a crisis, but it is the typical configuration that leads to one within 12 to 18 months. Decisions: chase and escalate old receivables, review indirect cost rates in new proposals, freeze non-essential overhead spending, and present the board with a plan to rebuild reserves.

Exercise: diagnosing a national NGO

Situation. A national NGO, annual expenditure 3,000,000 USD, of which overhead costs 360,000 USD. Funds 270,000 USD, of which 90,000 USD in vehicles. Cash 520,000 USD; unspent donor advances 430,000 USD; supplier and salary payables 140,000 USD; receivables from donors 210,000 USD; other current assets 20,000 USD. Income: donor A 60%, donor B 25%, donor C 15%. Shared costs recovered: 270,000 USD.

Tasks. Calculate: 1) current and quick ratios; 2) free reserves and months of reserves on overhead costs; 3) HHI; 4) shared cost coverage. 5) Diagnosis and three recommendations.

Answer. 1) Current assets = 520,000 + 210,000 + 20,000 = 750,000; current liabilities = 430,000 + 140,000 = 570,000. Current ratio = 1.32; quick ratio = 520 / 570 = 0.91. 2) Free reserves = 270,000 − 90,000 = 180,000 USD; monthly overhead costs = 30,000; months of reserves = 6. 3) HHI = 0.36 + 0.0625 + 0.0225 = 0.445. 4) Coverage = 270,000 / 360,000 = 75%, i.e. a shortfall of 90,000 USD a year. 5) Diagnosis: reserves adequate today (6 months) but an annual shortfall of 90,000 USD would halve them in a year; heavy dependency on donor A. Recommendations: negotiate a realistic indirect cost rate and budget shared costs as direct costs in every new proposal; diversify with at least one new institutional donor within 18 months; set a reserves policy at board level (target and rules for use) and monitor shared cost coverage every quarter.

Key takeaways

- An NGO's cash often contains donor advances that do not freely belong to it.
- Months of reserves = free reserves / monthly expenditure; always state the denominator.
- HHI = sum of the squares of the shares of income sources; the higher it is, the more dependent the organisation.
- A low overhead rate is not proof of efficiency; what matters is that necessary costs are covered.
- Shared cost coverage below 100% = erosion of reserves, year after year.

Quiz

1. Current assets 900,000 USD, current liabilities 750,000 USD. The current ratio is:

   A. 0.83

   B. 1.2

   C. 1.5

   D. 150,000

2. Free reserves 240,000 USD, annual overhead costs 960,000 USD. Months of reserves on overhead costs:
   A. 3
   B. 4
   C. 2
   D. 0.25
3. Three donors at 50%, 30% and 20%. The HHI is:
   A. 0.33
   B. 0.50
   C. 1
   D. 0.38
4. Actual shared costs 500,000 USD, recovered 400,000 USD. Coverage is:
   A. 125%
   B. 20%
   C. 80%
   D. 100%
5. The nonprofit "starvation cycle" refers to:
   A. Food crises
   B. Chronic underinvestment in overhead costs caused by the expectation of low overheads
   C. The end of projects
   D. Late payments

Quiz answers : 1. B · 2. A · 3. D · 4. C · 5. B