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Course handout · Week 5 : NGO finance: donor budgets, indirect costs and financial management

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Week 5 : NGO finance: donor budgets, indirect costs and financial management

Objectives

- Build a complete and defensible project budget: direct costs, shared costs, indirect costs, exchange rates and inflation.
- Understand the economics of an NGO: restricted and unrestricted funds, full cost recovery, reserves and cash flow.
- Manage financial performance: burn rate, variances, forecasts, cost per beneficiary and cost-effectiveness.

The economics of an NGO: what senior managers must master

An NGO funds its activities with two types of resources: **restricted funds** (donor grants tied to a project, to rules and to a budget) and **unrestricted funds** (private donations, core contributions, margins on indirect costs), which the organisation uses freely. Unrestricted funds pay for what donors do not: pre-financing of projects, ineligible costs, fundraising, systems investment, and **reserves**.

The sector's structural problem is the **under-coverage of indirect costs**. A frequently cited study (Bridgespan, "The Nonprofit Starvation Cycle", 2009) described the starvation cycle: donors fund too little of the overhead, organisations under-report these costs to look efficient, and end up lacking systems, qualified staff and controls, which increases the risks of fraud and failure.

Financial health indicator	Formula	Prudent benchmark
Free reserves in months	Available own funds / average monthly expenditure	3 to 6 months
Liquidity	Available cash / next month's expenditure	At least 1.5
Dependency on the largest donor	Largest donor's funding / total resources	Less than 40%
Indirect cost coverage	Indirect costs recovered / actual indirect costs	100% or more

Building a defensible project budget

A budget is built from the **activities** (activity-based budget), then presented in the donor's format (budget headings). Each line rests on a **quantity**, a **unit**, a sourced **unit cost** (quotation, history, market price) and a **percentage charged** to the project.

- **Direct costs**: inputs, project staff, transport, training, cash transfers.

- **Shared costs** (or shared direct costs): field office, vehicles, security, support staff used by several projects. They are allocated according to a documented and consistent **allocation key** (time spent, floor space, kilometres, share of the direct budget). Their total charged across all projects must never exceed 100% of the actual cost.
- **Indirect costs**: headquarters, central functions, governance. They are covered by a flat rate set by the donor (for example 7% of eligible direct costs in European Commission humanitarian agreements and in many UN agreements) or by a negotiated rate.

Two financial risks must be budgeted explicitly: the **exchange rate** (if the contract is in EUR and spending is in a local currency pegged to the USD) and local **inflation**, which can exceed 30% a year in some crisis countries. They are handled with realistic unit prices, a revision clause in the contract, or a contingency line when the donor accepts it.

> A donor reviewer checks three things first: the link between the budget and the logframe (every result has resources), the justification of unit costs, and the consistency of the allocation key for shared costs.

Indirect costs and full cost recovery

Full cost recovery means getting each project to fund its fair share of all the costs required, whether direct, shared or indirect. It requires knowing your true indirect cost rate.

Worked example. An NGO has USD 10 million in direct programme costs and USD 1.3 million in headquarters and central function costs. Its true rate is 1.3 / 10 = 13% of direct costs. If 70% of its funding comes from donors who pay 7%, the costs recovered are 7 × 0.7 = 4.9 points, plus 13 points on the remaining 30% (if those funds cover costs in full), i.e. 4.9 + 3.9 = 8.8% recovered against 13% actual costs. The shortfall of 4.2% of direct costs, i.e. USD 420,000, must be covered by unrestricted funds or by cutting costs.

Levers to reduce this shortfall: have costs that can legitimately be charged recognised as shared direct costs (security, field support), negotiate a certified indirect cost rate where the donor allows it (for example the negotiated rate in US government cooperative agreements, or failing that the de minimis rate provided for in its regulations), pool support functions, and turn down funding that deepens the shortfall without strategic value.

The same rule applies to local partners: passing on a share of indirect costs to them (for example half of the rate received, or their own rate) is a condition of their institutional strength and a commitment made by many Grand Bargain signatories.

Budget monitoring: variances, forecasts and cash flow

The monthly **budget versus actuals** report (BvA) compares, for each line, the budget, cumulative spending, the burn rate and the remaining balance. It only becomes meaningful with a **forecast** to the end of the project: actual spending + commitments + forecast for the remaining months. The variance to explain is not the past variance, but the variance forecast at the end of the project.

Example. 12-month project, budget USD 600,000, in month 8: spending 330,000, commitments (orders placed but not paid) 60,000, forecast for the remaining 4 months 140,000. Forecast final spending: 530,000, i.e. an underspend of USD 70,000 (11.7%). The raw burn rate (330 / 600 = 55% for 67% of the time) did not show this as clearly. Decision: reallocate to a priority activity within the flexibility limit, or request an amendment, at least three months before the end.

Cash flow is a separate risk: many donors pay in instalments, often after reports have been approved, and some reimburse after expenditure. A 6- to 12-month cash flow plan matches expected receipts with planned expenditure across all projects, so that the need for pre-financing from own funds can be anticipated.

Cost per beneficiary, cost-effectiveness and value for money

Donors and boards increasingly ask organisations to demonstrate **value for money**, often broken down into the British government's "4 Es": **economy** (buying inputs at the right price), **efficiency** (converting inputs into outputs), **effectiveness** (converting outputs into outcomes), **equity** (reaching the most vulnerable, even if it costs more).

Cost per beneficiary is a misleading indicator when used alone: reaching people in remote areas or people with disabilities costs more, and that is often where the greatest needs are. **Cost-effectiveness analysis** relates costs to a comparable outcome. The IRC has developed a method and a tool (Dioptra) to compare the cost per result of similar programmes.

Example. Two modalities to cover the food basket of 1,000 households for 6 months: in-kind distribution, USD 420,000 all-inclusive; cash transfers, USD 330,000 of which 270,000 is transferred to households. Transfer ratio: 270 / 330 ≈ 82% for cash. If markets function and the effect on consumption is comparable, cash is more cost-effective; if food price inflation exceeds 25% over the period, the conclusion may be reversed, hence the importance of market monitoring.

Exercise: budget, shared costs and forecast

Part 1. A field office costs USD 18,000 a month (rent, security, vehicles, support staff). Three projects use it: A (direct budget 900,000), B (600,000), C (300,000). Allocate the monthly cost according to share of direct budget, then explain why C's donor could challenge this key if C accounts for 50% of travel.

Part 2. 18-month project, budget EUR 1,500,000, in month 12: spending 870,000, commitments 110,000, forecast for the last 6 months 420,000. Calculate the forecast final spending, the variance in EUR and as a percentage, and propose two decisions.

Answer key. Part 1: A 50% (USD 9,000), B 33.3% (6,000), C 16.7% (3,000). If C generates half of the travel, a single key based on budget can be challenged: use different keys for different types of cost (kilometres for vehicles, time spent for staff). Part 2: 870 + 110 + 420 = EUR 1,400,000; forecast underspend of EUR 100,000, i.e. 6.7%. Decisions: reallocate to a high-impact activity within the flexibility limit, or a no-cost extension if the variance comes from a delay; proactive communication with the donor.

Key takeaways

- Unrestricted funds: pre-financing, ineligible costs, investment, reserves (benchmark 3 to 6 months).
- Budget = quantity × sourced unit cost × % charged; shared costs with a documented key, never more than 100%.
- Calculate your true indirect cost rate and the coverage shortfall it creates.
- Manage the forecast final spending (actuals + commitments + forecast), not just the burn rate.
- Value for money: economy, efficiency, effectiveness, equity; cost per beneficiary alone is misleading.

Quiz

1. An NGO has USD 20 M in direct costs and USD 2.4 M in actual indirect costs. All its donors pay 7%. What is its annual indirect cost coverage shortfall?

   A. USD 0.4 M

   B. USD 1.0 M

   C. USD 1.4 M

   D. USD 2.4 M

2. In month 9 of a 12-month project (budget 400,000): spending 250,000, commitments 40,000, forecast for the last 3 months 90,000. The forecast variance at the end of the project is:
   A. Underspend of 150,000
   B. Underspend of 20,000 (5%)
   C. Overspend of 20,000
   D. No variance
3. What is the main risk of a poorly designed allocation key for shared costs?
   A. The report is longer
   B. Costs charged beyond 100% or unrelated to actual use, therefore ineligible and comparable to double charging
   C. The donor pays faster
   D. None, donors do not check
4. In the "4 Es" of value for money, choosing to serve a remote camp that costs more per person because needs there are most severe falls under:
   A. Economy
   B. Efficiency
   C. Equity
   D. Effectiveness
5. A contract is denominated in EUR, and salaries are paid in a local currency that loses 20% against the EUR during the project. All else being equal:
   A. The project will run short of funds
   B. The EUR cost of salaries falls: an exchange gain arises, to be declared and used according to the donor's rules
   C. Nothing changes
   D. The donor must pay a top-up

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