Financial Management in a Local Government Association (LGA)

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As a board or staff member of a Local Government Association (LGA) you are confronted with many financial challenges. How to ensure expenditures do not exceed revenue? Which membership fee should be raised? How to become financially independent and how to plan and control the budget?

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Colophon

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Introduction

One of the most common challenges for local government associations (LGAs) around the world is to have enough financial resources to fulfil their core functions. These core functions are to represent the interest of their members, the local governments of the country; to provide services to these local governments and to offer them a platform for exchange and mutual learning. Over the years, VNG International has been supporting many associations with technical advice, including on the management of finances and resources.

This manual aims to provide useful insights to help the LGA members, the Board of Directors and LGA managers in addressing the challenges of financial sustainability of their association. This document focuses on national associations, because sub-national and supranational associations face different financial challenges.

An association can temporarily overcome its financial limitations with support from external partners, such as donors or the national government, but in the long run, the financial sustainability of the association depends on the association's capacity to represent the interests of its members in the political arena, through lobby and advocacy, and to provide the services that the members need and are willing to pay for.

Equally important is the national context of the association, for example if the local governments have financial constraints because of limited fiscal decentralisation or low income; the association's financial sustainability is thus a reflection of its members' financial capacity.

Financial management is the ability to prioritise and reconcile unlimited demands and needs with limited financial resources. To that end, a planning and control cycle has been developed. Taking the association's multi-annual strategic plan as a basis, a number of financial tools exist to support the planning and control cycle, such as annual and multi-annual budgets, progress reports and final accounts.

The strategic plan and financial tools are logically inter-linked and each of them has its specific function in the financial management process. The strategic plan sets the organisation's long-term direction, defines the values and aspirations, the objectives, programmes/projects and activities. At the same time it defines the strategy and the resources needed for the achievement of these priorities: human resources, technology, information, equipment, etc.

Many LGAs in a developing country context do not yet have a well-established planning and control cycle. Strategic plans are often mere 'wish-lists', as there is no connection between the strategic plan and the association's limited financial capacity. A realistic multi-annual budget is often missing. Moreover, quite often the annual budgets and final accounts do not reach the ‘statutory-required’ level, and they do not provide the necessary information for good financial management and accountability.

This manual tries to provide guidance for the development and implementation of a planning and control cycle.

The starting point is the development of a financial strategy as integral part of the association’s overall strategic plan, followed by templates of the specific tools of the cycle. Throughout the manual, several cases are presented to demonstrate how some associations have implemented methods and tools to improve their financial management.

• Part 1
Financial strategy

The multi-annual strategic plan is the main policy document of a local government association. The Board leads the strategic planning process with the assistance of the Executive Director. With this document, the Board determines the association's mission and objectives, the way they want to accomplish them, how much it may cost and how to finance these. Once approved by the membership, the strategic plan should serve the Board as a framework and guideline for future decision-making, and for seeking external support as an additional resource to realise the mission and strategic objectives. Furthermore, the strategic plan is the starting point for the Executive Director and LGA staff to develop and implement operational plans.

The strategic plan[1] (VNG International, 2005) sets priorities and establishes future direction for all areas of the organisation by providing answers to three basic questions:

- What do we want to achieve? (Policy level);
- How are we going to do it? (Organisational level);
- How much will it cost? (Financial management level).

From a financial perspective, strategic planning is about making choices between competing demands for limited financial resources. The bottom-line is simple: an organisation, in order to survive in the medium term, cannot spend more resources than it is able to acquire.

Unfortunately, strategic planning is often done independently from financial planning. Revenues may be allocated and used to solve routine problems instead of being targeted towards issues that really matter. The result is an ineffective process, where one is unable to choose from competing priorities and achieve the association's goals. The strategic plan and the budget must be connected, so that funding priorities in the budget are aligned with the priorities of the association.

A good strategic plan should include two financial elements:

1 A section that considers finances as a strategic objective by itself, setting out strategies to strengthen the association's future revenue base so as to guarantee long-term financial sustainability and independence;

2 A comprehensive financial chapter listing the costs of all services and activities included in the strategic plan, and the resources with which they will be financed.

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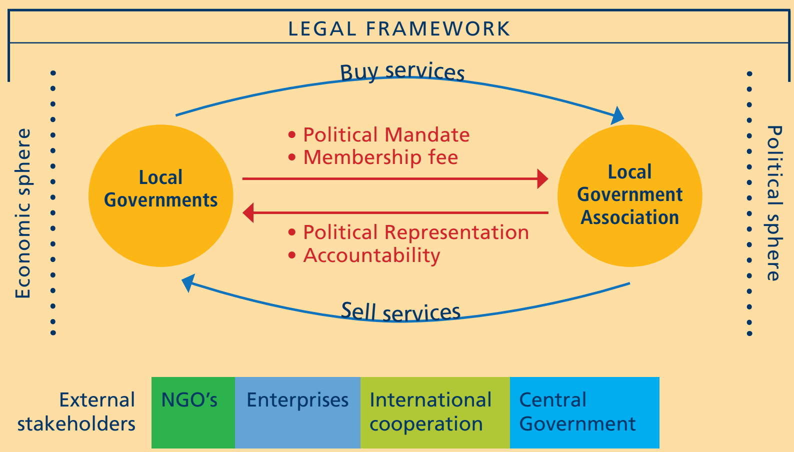
1 See the VNG International manual Strategic Planning in an LGA – downloadable from www.vng-international.nl/publications-tools/english-language-publications.html

1 Financial sustainability

An association is financially sustainable when it is able to generate sufficient revenues to perform its fundamental function and deliver some core services up to a minimum acceptable level.

Generally, the core function of an association is the representation of local governments' interests by means of participation in the national political dialogue, and the definition of public policies. Core services include helping members to carry out their legal competences and being a platform where municipalities can exchange information and learn from each other.

Graphic 1: Spheres of financial sustainability



On the one hand, the Board must ensure that the LGA has the financial support to represent the interests of its membership (political sphere), as this is the main purpose of the association. On the other hand, the membership of the association should decide which services they expect from the LGA and what they consider as minimum acceptable level for each of these services (economic sphere). The association should then be able to determine the costs involved in providing these services.

The association has to consider potential competitors and it must ensure that its services are competitive, offering good value-for-money to the members.

The relation with external stakeholders is also an important element in terms of obtaining financial support for the implementation of specific activities or projects.

CASE 1: FINANCIAL SUSTAINABILITY OF A LOCAL GOVERNMENT ASSOCIATION IN EAST AFRICA

A financial analysis showed that the revenue-base of the association was not sufficient to perform its core functions at a sustainable level. To amend this situation, a substantial rise in membership fee was needed.

(NOTE: Other possible options could have been to launch income-generating activities or to ask the Central Government for a contribution, however such solutions were not advisable: income-generating activities demand business skills that the association's personnel did not possess and a Central Government contribution could jeopardise the association's independent lobbying function.)

The only way to substantially improve the association's financial capacity was in the hands of the membership. If the members acknowledged the importance of the association, they had to provide it with the necessary means to perform its functions properly by increasing the membership fee. There were two ways to reach this goal:

1 An increase of the existing flat rate for all members; or
2 The introduction of a graduated fee structure.
A substantial increase of the flat rate, however, could cause problems of affordability, especially for small, rural districts with a very limited revenue base. For that reason, it was suggested to introduce a graduated system that would reflect solidarity amongst the members.

It was recommended that:

1) The association should introduce a new membership fee system based on the existing grading system for the districts, as determined by the law.
2) The fee for each district should be determined according to the formula (A x B x C) in which:
   A = an existing flat-base amount for each district;
   B = the factor for rural or urban, in which "rural district = 1" and "urban district = 2";
   C = the factor for the legally determined district grade, in which each grade pays 10% more than the previous one. Example:
   grade 1 = factor 1
   grade 2 = factor 1.1
   grade 3 = factor 1.2
3) Each year the Base amount (factor A) would be adjusted for inflation.
4) The Urban/Rural factor (B) could be used to increase or decrease the distinction between rural and urban districts.
5) The Grade factor (C) could be used to vary the amount to be paid for each distinctive grade and thus refining the fee structure in accordance with the relative financial capacity for each grade.

The above proposed fee structure was intended to increase the association's revenue base by almost 50%, which would be sufficient to perform its core activities on a sustainable minimum acceptable level.

2 Financial independence

From the outside, an association might look financially sustainable because it is able to pay its bills in time and keep its operations running. But is that association really sustainable? Many LGAs depend on external support, such as donors or central government, to cover a considerable part of their budgets.

Table 1: Comparative chart of revenues from associations in Central America & Mexico

Sources	AMUNIC Nicaragua	COMURES El Salvador	UNGL Costa Rica	ANAM Guatemala	AMMAC Mexico
Membership fees	33%	59%	75%	50%	37%
Central government transfers	15%	29%	0%	37%	
Donors	52%	12%	8%	8%	
Paid services					57%
Other			17%	5%	6%
Total	100%	100%	100%	100%	100%

Source: VNG International financial sustainability assessments. Rafael Quintero, 2007

This dependence might be a threat for future financial sustainability, because donors do not stay forever and the support of central government might be subject to political changes. What will happen when they reduce or withdraw their support? Would the association be able to perform its core function and services with the remaining resources? If not, a financial strategy should be developed in order to reduce donor dependence and lead the association to real financial sustainability.

Another non-financial aspect might be that central government, and sometimes donors, may use their financial support in order to interfere with, or exercise influence and control over the association's political agenda. Ideally, financial assistance should only be accepted when it is supportive of the association's mission and strategic objectives. In this respect, a strategic plan is a helpful communication and negotiation tool to ensure donor support is aligned with the association's priorities.

An association is **financially independent** when it is able to generate enough structural (non-external) revenue in order to perform its key function – representing the interest of its members – and provide services up to a minimum acceptable level (in terms of quantity, quality and timing) that the members need, demand, and are willing to pay for.

In operational terms, the golden rules for financial independence are that:

- The association maintains balanced (multi-annual) budgets, in which expenditure does not structurally exceed revenues. Modest reserves are desirable in normal circumstances.
- The association finances its core function and services from structural revenues only and not from one-off or temporary revenues.
  - > *Structural* revenues are those that provide a steady flow of income because they recur every year, such as membership fees, profit from paid services and other activity-related income. Donor money can never be structural.
  - > *One-off* revenues are those obtained to perform a given activity.
  - > *Temporary* revenues are those that recur, but only for a limited time.
- The association spends its non-structural revenues only on non-structural activities such as investments, special events or projects.

Table 2: Match costs, timing and source of revenue

Specific revenues	Specific expenses
Membership fees (structural)	Expenses on core function and services (structural)
Revenue from sales of goods and services (demand-driven)	Costs incurred in selling goods and services (demand-driven)
External funds for activities / projects (temporary or one-off)	Activities / projects and related expenditures (temporary or one-off)

Example 1: Towards financial sustainability – an LGA in Eastern Europe

An LGA in Eastern Europe was heavily dependent on donor money. In order to become financially independent, it developed a strategy for financial sustainability to reduce the budget share of donor money from 93% to 20% in two years. This balance between the LGA own money and donor sources guaranteed that core activities could be paid for by structural revenues.

Strategy for financial stability

Objective	Milestone	Responsibility	Deadline
Objective 5.1 Develop a strategy on revenue raising and efficient use of revenues, within 2011	5.1.1 Establish a Commission for Strategic Development	Steering Committee	October 2010
	5.1.2 Develop the membership fee scheme needed to reach financial sustainability	Steering Committee	April 2011
	5.1.3 Approve the membership scheme	General Assembly	06 July 2011
	5.1.4 Develop the Strategy	Commission for Strategy	20 July 2011
	5.1.5 Approve the Strategy	Steering Committee	20 July 2011
Objective 5.2 Increase the rate of fee-paying members to 90% of overall membership by end of 2012	5.2.1 Raise awareness of Communes on membership fees payment	Economic Commission	Throughout the year
	5.2.2 Develop and approve an incentives programme for paying members	Steering Committee	Second half of 2011 – first half of 2012
	5.2.3 Organise regional meetings to encourage payment of membership fees	Finance Commission	First trimester of each year's payments

Objective	Milestone	Responsibility	Deadline
Objective 5.3 Generate 5% of annual budget from paid services provided by the LGA to its members	5.3.1 Identify the core and fee-based services to be provided by the LGA to its members	Executive Committee	End of 2011
	5.3.2 Approve the list of core and fee-based services for the coming year	Steering Committee	End of the third quarter of each year
Objective 5.4 Raise 1% of the LGA annual budget from the private business sector	5.4.1 Determine the ability to incorporate private advertising in materials and publications	Steering Committee	October 2011
	5.4.2 Determine the rate and criteria for advertisements	Steering Committee	December 2011
	5.4.3 Conduct a public policy campaign to inform businesses about the LGA and generate joint venture opportunities with private businesses	Members of the Steering Committee	Starting from December 2011 onwards
Objective 5.5 Reduce contributions from donors to 20% of LGA budget, within three years	5.5.1 Contact donors to present the association's strategy	Chairman	On-going

3 Revenues

Local government associations typically rely on the following types of sources:

- Internal sources
  > Membership fees
  > Paid services
- External sources
  > Donor support
  > Central government support
  > Other sources

Some associations may have an additional source of income in the form of in-kind contributions, such as municipal staff seconded to the association, office space or secretarial services made available by a municipality or events paid for by a hosting municipality. Although these in-kind sources of income can be important, and even vital for the functioning of the association, they are non-monetary in nature and for that reason they do not feature in the budget or accounts of the association.

Only the first two types of sources are self-generated and considered as structural or recurring revenues. These revenues are the reflection of the association adhering to its political mandate, and the demands and expectations of its members. These revenues allow the members to hold the association accountable.

Although it may seem a good short-term policy to obtain as much financial donor support as possible, the LGA should aim to become independent and sustainable, financing its core function and services from structural resources, because donor support is always time-limited. Donor support should be allocated to one-off expenditures like start-up activities, investments, or special activities that contribute towards the accomplishment of the strategic plan.

Some LGAs receive significant financial support from their central government. The conditions associated with receiving funds from a central government should be carefully analysed, and LGAs should aim not to rely heavily on such funding, as it can weaken the political position of the association when comes to time to represent the interests of the local governments vis-à-vis the central government.

Other sources of revenue can include support from the private sector to organise specific events such as a municipal fair; sponsorship of the General Assembly by NGOs or private enterprises; or collaboration with a university to develop training courses for the members.

3.1 Membership fee

Membership fees are the single most important source of income for any LGA and therefore the cornerstone for long-term financial sustainability.

Membership fees are used for operational costs (office rent, basic services, communication, salaries, etc.) and to finance recurrent costs related to the political representation function (advocacy and lobby). Depending on the peculiar conditions of the country, the membership fee might also include such services as:

- Networking;
- Broadcasting municipal programmes and producing printed materials;
- Managing databases of economic, demographic, fiscal and legal data; and
- Providing legal and financial advices.

When deciding on membership fees, the LGA should conduct a thorough analysis of the capacity to pay of the local governments to ensure it is asking for realistic contributions.

Three issues are important in defining the membership fee:

1 The total amount that should be collected from the membership;
2 The way this amount will be prorated among the members; and
3 The collection mechanism itself.

As a principle the membership fee should be budget-related, i.e. the amount that will be collected from the membership should cover the budgeted costs to perform the association's core function and services. The next step is to decide on a fee structure and how it will be shared among the members. The LGA can opt for a flat fee or a differentiated fee system.

3.1.1 Flat fee

Advocates of a flat fee system argue that all members are equal, have equal voting rights and should therefore pay an equal amount of membership fee. This approach is the most simple to manage and has the appearance of fairness.

However, the system is only recommendable when all the members have similar capacity to pay. When there are considerable budget differences between municipalities (large and small, rural and urban), a flat-fee system might result in membership fees that are too high for the budget of some smaller/rural members. In such cases a differentiated fee system could be more appropriate.

The pros and cons of the flat fee method are:

Pros	Cons
• It is easy to calculate and collect. • Responds to the idea of equal rights mean equal obligations (equality vs. fairness).	• If the flat fee is enshrined in the association's constitution, it is inflexible and will not reflect changes in prices over time. • It is unfair and burdensome for small, rural or poor local governments, who have to contribute the same amount of money as larger and richer members. • If the LGA settles on a low membership fee in order to make it affordable for its smaller, rural or poorer members, the association may become unsustainable. • In countries, where there is a small number of local governments which can join and become members, the LGA must ask a high flat fee.

3.1.2 Differentiated fee

When the differences in members' capacity to pay are significant, a differentiated fee is advisable. This system shows solidarity of the bigger members with their smaller colleagues without implying a differentiation in voting rights.

To establish the membership fees' structure, the LGA should look for an objective measure that is aligned with municipal revenue and acceptable to the majority of members. Although the size of the municipal budgets would be the ideal measure, it is a rather time-consuming task to collect all necessary data. Moreover, the quality of the municipal budget, especially in small municipalities and in rural areas, does not always reflect the member's real financial situation.

To calculate a differentiated fee, most LGAs use as references:

1 The number of inhabitants;
2 The area of the municipality; and/or
3 Fiscal transfers from central government plus own revenue for larger municipalities.

All three measures have a certain correlation with the capacity-to-pay of local governments.

1 The number of inhabitants correlates positively with expenditure on social basic services such as education and welfare, as long as these services are part of the legal competences of local governments.
2 The area of the municipality correlates positively with expenditure in the construction and maintenance of municipal infrastructure in the territory.

3 On the revenue side, in the majority of developing countries, local governments' revenues rely almost entirely on central government transfers; only a few big municipalities are able to generate a significant amount of own revenues and, generally, they have solid and reliable reporting systems (this fact also impacts on the financial sustainability of an association because fiscal transfers are usually done for specific purposes, leaving little room for the local government to spend on other items.) Fiscal transfers generally combine several criteria like the size of population or territory, but might also include some equalisation criteria in order to compensate disadvantaged areas (e.g. poor and remote areas, with small and scattered population and minorities) or incentives for the collection of local revenue, both with clear impact on the financial situation of municipalities.

Even though this method represents more effort in the collection of data, it is more representative of the local governments' capacity to pay the LGA membership fee.

Of course, it would be possible to design a membership fee structure on the basis of several criteria but transparency and ease of the formula have to be taken into account. It is also important to find a formula that avoids extreme situations, such as in Nicaragua where the capital, Managua, represents 50% of the LGA's potential fee. To avoid such situations, it is advisable to define a ceiling and a floor, for example that no municipality should pay less than 0.5% or more than 20% of the LGA's total membership fees.

The pros and cons of the differentiated fee method are:

Pros	Cons
• It is equitable and adapted to the actual capacity to pay of the members. • It stimulates solidarity because larger municipalities support the smaller ones via the services of the association.	• Depending on the criteria, it may be difficult to obtain the correct data to determine the fees. • If there is no ceiling and floor in the fees structure, the differences in terms of contribution could discourage larger municipalities. • Larger members may be under the impression that paying more fees should give them more rights; this challenge has to be solved through the governance system of the association. • Larger members are often able to advocate and lobby by themselves because they have more administrative, technical and managerial capacity; they may feel they do not need some of the services offered by the association and consider their bigger fees as a kind of cross-subsidy. • The smaller members, who usually constitute the greater part of the association's membership, may oppose the bigger members and try to gain control of the association.

3.1.3 Membership fee collection

Once the fee structure has been agreed upon, all members should be informed about their dues along with the procedures and modalities for payment. It is vital to also inform the members on what they will receive in return for their money: this is fundamental for the justification of the level of the membership fee and for the very existence of the association. Furthermore, members should be informed on the measures that will be applied in case of default.

All members – whether they are duly paying their fees, are defaulting or inactive – will benefit from the association's progresses, such as a new law or a development policy lobbied for by the LGA. If the association is not able to create a sense of belonging and a sense of purpose among its members, the incentives to become a 'free rider' are high.

The discipline of paying fees is rather low in many countries: some associations collect less than 50% of the statutory membership fees.

Since the financial health of an association is the reflection of its political health, it would be important to review the governance and the achievements of the association if fee collection is low.

- Are the members' involvement and participation considered in the most important decisions?
- Are the Executive Director and the governing bodies being held accountable?
- Are there positive outcomes to the actions implemented?
- Is the information above communicated effectively to the members?

In that sense the payment of the membership fee is a measure of satisfaction of the members with the association.

Because membership fees are generally the single largest resource for any association, it is paramount to introduce and apply procedures for an efficient fee collection. The LGA financial staff should prepare monthly management reports for the Executive Director and the Board, showing the fee collection rate as well as a list of members who are in arrears. Based on these reports, the Board can decide on further actions. Possible measures include:

- Regular phone calls to defaulters by the financial staff (for example, once a week or fortnight)
- Special phone calls by the Executive Director and/or Board members (once a month)
- Rewards for early payment and penalties for late payment
- Publication of arrears on the association's website and/or newsletter
- Active involvement of the regional branches
- No entitlement for defaulting members to participate in specific activities as long as arrears exist (training workshops, seminars, study trips abroad, etc.)
- No unpaid services as long as arrears exist
- No voting rights as long as arrears exist

Some associations, like in the ones in Ghana, Cameroon, Ecuador and Montenegro, do not face the problem of low collection rates because they receive the membership fees directly from central government, either in the form of a lump sum legal entitlement or as a deduction from financial transfers to individual municipalities. The advantages of such systems are obvious: collection is very efficient with almost no cost attached and a 100% collection rate. Nevertheless, there may be some disadvantages, especially regarding the association's independence and alignment with the demands and expectations of its members. Some of the aspects to be considered are:

- Has the association the right to determine the fee in line with the costs of its strategic plan or is the amount determined by central government? In the latter case, central government could exercise political influence and control over the association's agenda, jeopardising its independent lobbying function.
- Is there a formula to adjust the fee from year to year? Is the formula established by law or is it at the discretion of a specific minister? Again, in the latter case central government could interfere with the association's priorities.
- Are municipalities free to choose whether or not to become members of the association? This may have an impact on their sense of ownership and their opinion of the association.
- What do the municipalities receive in return for their fees? The association must not become complacent and the Board and Executive Director have to ensure that the LGA continues to offer value-for-money to the membership.

The best way to avoid such obstacles would be to introduce a system in which the membership voluntarily accepts that central government withholds the membership fee and transfers it to the association. Such a system should be based on the following elements:

1 The Board determines the fee, based on the costs of the approved strategic plan and the commitments of the association.
2 The General Assembly discusses the Board's proposal and approves the fee.
3 Each member signs an individual agreement with the association to allow central government to withhold the fee.
4 The agreement can be revoked or ratified on an annual basis.
5 The association signs an agreement with central government in which the withholding and transfer procedures are outlined.

3.2 Paid services

Not all LGAs are in the same phase of development. Some perform an extensive range of activities and offer their members a variety of services. Others still restrict themselves to the most basic function: political representation lobby and advocacy activities.

The Board of each association should decide, in consultation with the membership, which services they consider to be paid collectively from the membership fee and which services they will provide as paid services, either paid by the individual users or groups of users. Members must have realistic expectations with regard to the services offered by the LGA.

The Board must also analyse the strategic added value of each one of the paid services offered by the LGA and the potential competitors in the public or private sector. All services of an association – with the exception of political representation – are subject to competition from external service providers. Services such as publishing/printing, training courses, etc., must be competitive with the services offered in the market. A realistic business plan is needed to establish any specific service and it must be considered as a cost-centre or a subsidiary company, avoiding unnecessary subsidies and ensuring full cost-recovery from the beginning.

Economies of scale, specialisation, quality and trust of the membership are important elements to be considered by the association at the moment of deciding to start offering a specific service.

3.2.1 Economic criteria for including/excluding services in the membership fee

The first economic criterion for the inclusion or exclusion of services in the membership fee is the ability to exclude non-payers from a service.

When there is no effective method to prevent non-payers to benefit from the service, the costs should be paid collectively, via the membership fee. On the other hand, when it is easy to identify the beneficiaries and there is a possibility to exclude non-payers, individual or group charges are recommendable.

The second criterion is the rivalry in the consumption of the services. Rival services can only be used by one member at a time. For example, if the association has only one professional in charge of providing legal assistance to the municipalities, the time devoted to a specific municipality impedes other municipalities to benefit from this service at the same time. When there is no rivalry in the consumption of services, like radio broadcasting or public relations, these services should be included in the membership fee. But when there is rivalry in the consumption of a service, the costs have to be paid individually.

The core function of the association, which is the political representation of local governments, is not considered in this analysis but it fulfils the two criteria: no exclusion and no rivalry in the benefits. That is why political representation has to be fully covered by membership fees.

Services generally covered in the membership fee include:

- Public relations and institutional representation (national and international);
- Communication and information broadcasting;
- Coordination and networking;
- Platforms for exchange and learning;
- General databases (demographic, fiscal, economic, etc.).

Services not covered by the membership fees, but generally charged in-group (when the beneficiaries form an identifiable group of individual local governments), include:

- Formulation and implementation of activities (capacity development, training, etc.);
- Best practices projects;
- Event organisation;
- Specific research and database development;
- IT standard solutions like software applications for small, medium size and large municipalities.

The price must be prorated amongst the beneficiaries following certain criteria, such as regions or groups of municipalities that will benefit from the service.

Services and burdens generally charged individually, when individual beneficiaries are identifiable, include:

- Training courses, workshops, etc.;
- Auditing and accounting services;
- Technical advisory;
- Database access;
- Development of manuals, procedures and improvement of administrative systems;
- Central purchasing of supplies and stationery (if procurement laws allow it and if there is no moral hazard in the brokerage activities).

The LGA must work on a full cost-recovery basis for the provision of paid services; a feasibility study needs to be done prior to the launch of each service. This manual focuses on the financial aspects of paid services; a comprehensive analysis of the services provided by LGAs can be found in a separate manual produced by VNG International for local government associations (VNG International, 2007).

Associations that want to provide paid services should be aware of the following risk factors:

- Strong competition may already exist from private sector companies or NGOs;
- The association might be too small to develop and maintain high professional standards; and
- The association might not be able to acquire sufficient assignments to guarantee a steady workflow.

If these risk factors are not taken into consideration, they may cause a money loss for the association and in the end may consume part of the membership fee. Before embarking on a new revenue-generating service, it is recommended to do a thorough market analysis to establish the cost at which the service can be provided by the association, if there is demand at that price, and what the level of competition is.

Specialised knowledge of local affairs and trust play an important role in favour of the LGA. On the other hand, well-established companies that have been providing an efficient service to the municipalities over the years will have a definite advantage because of their reputation and experience in the market. In equal conditions of price, time and quality, local governments may prefer to buy services from their association but this is not guaranteed; the LGA should launch the new service with realistic expectations and an understanding of the market.

The paid services that associations provide can be classified in two groups: organisational and staff enhancing capacities; and professional services.

3.2.2 Organisational and staff enhancing services

Organisational and staff enhancing services encompass activities like providing training, developing curricula for courses, maintaining benchmark systems, producing manuals and disseminating good practices.
Some larger associations have even established their own training centres. In this respect, it is advised, whenever considering the development of such facilities, to pay full attention to the earlier-mentioned risk factors. The negative financial consequences may be rather large when demand falls short of initial expectations. A less risky alternative would be to design courses, attract trainers and hire facilities on a case-by-case basis, only when demand or needs occur. It is rather simple, in such specific cases, to determine a fee level that covers all cost, including a small profit margin, if desired.

Example 2: Calculation of training fee

As part of its revenue-raising strategy, an LGA had decided to raise at least 5% of total revenues from paid services. To that end it developed a template to determine the fee from training seminars, including a 3% profit margin.

Cost of event

Trainers		
Fee	3000	
Per diem	800	
Travel	400	
Other costs	200	4 400
Accommodation		
Rent for venue	2 000	
Hotel costs	4 000	
Food and drink	1 200	
Other accommodation cost	350	7 550
Materials/Services		
Stationery	300	

Printing	200			
Other materials	100			
Translation	300			
Interpretation	300			
Other material/services	200	1 400		
Overhead				
Cost of staff and equipment	500	500		
1) Total costs		13 850		
2) Number of expected paying participants		40		
3) Cost per participant (1:2)		346.25		
4) Profit margin for LGA (3%)		10.39		
5) Price per participant (3+4)		356.64		
6) Profit or loss	Revenues	Costs	Results	
40 participants	14,265.50	13,850.00	415.50	Profit
35 participants	12,482.31	13,850.00	- 1,367.69	Loss
45 participants	16,048.69	13,850.00	2,198.69	Profit

Note: This type of template can be used for any other fee calculation purpose.

3.2.3 Professional services

The most common professional services offered by LGAs are in the field of accountancy, auditing, research, legal advice and IT services. They are typically on-request demands and against payment of a time-related fee. In the past, associations, especially larger ones like VNG in the Netherlands, have provided a number of these services; however most of them have gradually been privatised.

Example 3: Service fee calculation template

As part of its revenue-raising strategy, an LGA explored avenues to broaden its revenue base by providing paid services to its membership. The leadership asked to provide a template to determine the fee level as well as to simulate risks caused by insufficient assignments.

Example Profit/Loss on paid services

Costs	Budget	Final accounts
Salary	12,000.00	11,800.00
Office and materials	8,000.00	8,300.00
Travel and accommodation	6,000.00	6,900.00
Overhead	4,000.00	4,000.00
1) Total costs	**30,000.00**	**31,000.00**
2) Estimated number of days to be invoiced	150	
3) Actual number of invoiced days		120
Budgeted fee		
4) Cost per day (1:2)	200.00	
5) Profit margin 10%	20.00	
6) Fee per day (4+5)	220.00	

Final account versus budget

	Revenues	Costs	Results	
Budget	33,000.00	30,000.00	3,000.00	Profit
Final account	26,400.00	31,000.00	-4,600.00	Loss

Results: A budgeted profit of 3,000 turns out to be an actual loss of 4,600.
Reasons:
1The number of invoiced days was 20% lower than expected (120 instead of 150)
2The costs were 3.33% higher than budgeted (31,000 instead of 30,000)

Note: This type of template can be used for any other service fee calculation purpose.

3.3 Donor support

Donor support must generate change, helping the LGA to develop capacities in order to accomplish its core function; while delivering certain services that help the association to gain visibility among its members and enhance their willingness to pay membership fees. A clear exit strategy is an imperative from the very beginning, in order to avoid the erosion of the sense of ownership among the member local governments and to avoid the association's "addiction" to donor support. It is inappropriate to offer artificially inflated salaries, to sign up for to an expensive rent or to commit to costly recurrent services, as these expenses will become unaffordable in the future of the association.

Donor support may take three forms:

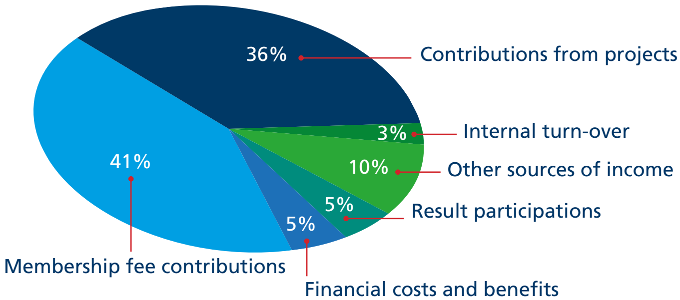
1. Temporary budget support for the institutional strengthening of the association itself (salaries, strategic planning, develop services, etc.), which sometimes requires counterpart funding from the association.
2. Payment of overhead costs for specific services rendered by the association while implementing projects that benefit local governments. As the association acts as an implementing agency and the final beneficiaries are the local governments, the beneficiaries must pay for the counterpart funding.
3. One-off donations for purposes such as start-up activities or services; for investments like office space, vehicles, equipment and the like; for special activities or events (training courses, seminars, fairs and exhibitions, publications, internships, business trips, exchanges, etc.).

3.4 Central Government

Central government can also be a source of revenue for an LGA. Even a well-established and centenary-old association like VNG in the Netherlands receives funds on a project-basis from central government in order to undertake activities that benefit local governments in the country.

CASE 2: VNG'S DIFFERENT SOURCES OF INCOME

In 2012 approximately 40% of VNG's income came from membership contributions. Following an LGA best practice, VNG manages its finances on the principle that its core functioning and related fixed costs should be covered by the membership fees, as other sources of income can fluctuate.



The other major sources of income come from projects implemented by VNG on behalf of the central government, mostly through the National Municipal Fund. VNG aims to execute these projects with staff it employs on a project (and thus temporary) basis.

This relationship is also common in developing countries, where the associations are in need of financial resources and national governments do not always have effective and legitimate channels to reach local governments for the implementation of national policies or for the implementation of capacity development projects.

CASE 3: TRANSFERS FROM CENTRAL GOVERNMENT AND LGA SUSTAINABILITY – EL SALVADOR

COMURES (Corporación de Municipalidades de la República de El Salvador) is an example of an LGA where a national law (the Law for the Creation of the Fund for the Economic and Social Development of Municipalities) establishes that the association is entitled to receive the equivalent of USD 500 000 annually with the purpose of strengthening the municipalities, allowing the association to assume its role as a representative of national and local interests, promoting the development process and ensuring the autonomy of municipalities.

For the correct use of these funds, COMURES is accountable to the National Parliament and to the National Auditing Office. COMURES is free to allocate these resources to the programmes that its members judge necessary for local development.

As has been mentioned earlier in this document, the conditions involved in receiving central government support must be analysed to ensure the association will remain neutral and able to represent the municipalities effectively when dealing with the central government.

The forms of central government funding to associations are similar to donor funding:

1 Temporary budget support;
2 Overhead costs for projects implementation on behalf of central government; and,
3 One-off donations.

3.5 Other sources of income

An association may try to enhance its revenue base by tapping into a variety of smaller resources: sponsoring, organising special events, and issuing printed materials. Additionally, whenever printed materials are issued, revenues can be generated from advertisement. Interested sponsors will typically be businesses that supply goods and services to municipalities or to the association itself. Although the funds generated by these sources might be rather limited, it is worthwhile trying to utilise this avenue as a way to maximise the association's revenue base.

• Part 2
The budget planning and control cycle

1 Planning

The budget **planning and control cycle** is a financial management process, supportive of the development and execution of an LGA's strategic plan. The most important tools used in the budget planning and control cycle are:

Planning tools:

- The **multi-annual budget** is a global financial translation of the strategic plan, typically spread over three to five years. It indicates how the costs of implementation are going to be financed and whether or not the organisation has medium-term financial sustainability.
- The **annual budget** is a detailed financial translation per year of the multi-annual budget. It should be the financial basis for an organisation's operational plan.
- The **capital investment plan** is a list of anticipated investments into tangible assets.

Monitoring and control tools:

- The **progress reports**, typically produced on a quarterly basis, are needed to monitor whether the financial implementation of the operational plans is in line with the allocated amounts in the budget and, if not, to detect the cause and to take remedial action.
- The **final accounts** can be viewed as a progress report for a full year. Furthermore, final accounts are a means, for the membership and other stakeholders, to hold the Board accountable.

A well-developed strategic plan accompanied by an adequate multi-annual budget can be a strong and persuasive communication tool for an LGA in search of financial and/or technical support.

1.1 Budget cycle timetable

As with any management process, the budget planning and control cycle requires organisation. The first step is the development of a work plan outlining the consecutive activities that make up the cycle. This section focuses on planning activities that are in direct relation with financial management.

The financial work plan should answer three questions:

- What should be done? (Activities)
- Who is going to do it? (Responsibilities)
- When should it be ready? (Deadlines)

The Executive Director together with the financial staff can use the work plan to monitor progress and to detect, discuss and solve any problem that might occur during implementation. Furthermore, the planning and control cycle is a recurring process; over time, a thorough work plan helps to establish strong routine procedures within the LGA.

Example 4: Budget cycle timetable template

A budget cycle timetable should provide the necessary financial management information and comply with the association's statutory requirements.

	Activity	responsible	Deadline
1 Planning: Budget preparation			
1	Revise the budget for the current year	Finance Officer	15 Aug
2	Draft the projected Balance Sheet and (multi-annual) budget for the upcoming year	Finance Officer	1 Sep
3	Draft budget statement for the upcoming year	Executive Director	1 Sep
4	Discuss and agree on the drafts to be submitted to the Council	Board	1 Oct
5	Review and submit to the Assembly the projected Balance Sheet, (multi-annual) budget and projects for the upcoming year	Council	1 Nov
6	Review and approve the projected Balance sheet, (multi-annual) budget and programs for the upcoming year	Assembly	01-Dec

2 Monitoring & Control:			
1	Draft the quarterly financial progress reports	Finance Officer	15 Apr / 15 Jul/ 15 Oct
2	Submit quarterly progress reports to the Board on finances and on activities	Executive Director	01 May / 1 Aug / 1 Nov
3	Prepare draft Balance Sheet and Profit & Loss Accounts for the past year	Finance Officer	1 Apr
4	Submit the draft Balance Sheet and Profit & Loss Accounts for the past year to the Board	Executive Director	15 Apr
5	Submit the Balance Sheet, Profit & Loss Accounts and programme from the past year to the Council and to the Finance Committee	Board	1 Jun
6	Scrutinise the Balance Sheet and Profit & Loss Accounts for the past year, and report to the Council	Finance Committee	1 Oct
7	Review and submit to the Assembly the Balance Sheet, Profit & Loss Accounts and programmes for the past year	Council	1 Nov
8	Review and approve the Balance Sheet, Profit & Loss Accounts and programmes for the past year	Assembly	1 Dec

1.2 Multi-annual Budget

The difference between revenues and expenditures is the budget balance. If revenues are higher than the expenses, there is a surplus that can be used:

- To deliver more services;
- To create a provision for future capital investments or future obligations; or
- To build a financial reserve as a buffer for contingencies.

If expenditures exceed revenues there is a deficit, which urges the LGA to reduce costs, for example by means of:

- Eliminating or reducing activities that do not add value to the mission like unnecessary meetings (sitting allowances) and travels of the members of the Board (governing structure costs);
- Monitoring the productivity of the staff, the costs associated with the staff and if necessary downsize the organisation;
- Reviewing organisational costs such as the use of equipment and office space;
- Reducing or eliminating certain non-essential services.

The other possibility to overcome the deficit is to raise additional revenues. However, associations should not only be concerned about the balance in one particular year, but should also look at the longer term and whether the pattern of surpluses and deficits can be predicted over time (structural balance).

Moreover, it is important to reach a certain stability of the balance from year to year, avoiding wide swings between surpluses and deficits. The goal should be to obtain modest surpluses in normal conditions and break even during economic downturns or challenging years, for example if a natural disaster has affected the members.

In order to predict future trends and to reach a certain stability, the LGA needs to develop multi-annual budgets. A multi-annual budget shows the financial consequences of the strategic decisions. It should also provide an indication about the financial sustainability in the mid-term (three to five years).

While a budget consists of recurring operational expenditure, a capital investment plan consists of expenditure in assets (buildings, vehicles, computers, office equipment, furniture, etc.), with a lifetime of more than one year and which cost exceeds a certain amount, for example EUR 500.

The capital investment plan secures that capital investments and their running costs are properly presented. Small associations, with limited capital investments, do not necessarily need a capital investment plan. They may decide to present capital investments directly in the respective functional part of the (multi-annual) budget. However, one should be aware that most capital investments come with running costs like maintenance, insurance, fuel, taxes and license fees, which should be taken up in the budget.

Example 5: Multi-annual budget aligned with strategic plan

An association's Steering Committee adopted a strategy for financial self-sustainability, which was the financial translation of the association's strategic plan. Its main goals were:

1 To provide the necessary revenues for the implementation of the LGA's planned services;
2 To reduce considerably the dependency on donor funds;
3 To introduce a fee structure that turned membership fees into the main revenue source;
4 To provide a balanced multi-annual budget for the 2011-2013 period.

The strategic plan resulted in the following multi-annual budget.

Budget line	2010 (executed)	2011 (planned)	2012 (planned)	2013 (planned)
1 Revenues	8,520,880	11,088,096	11,944,878	14,262,544
1.1 Projects (donor funded)	7,940,880	5,570,400	5,333,640	1,917,120
1.2 Membership fees	580,000	4,425,696	4,691,238	9,945,424
1.3 Paid services	-	420,000	600,000	720,000
1.4 Business advertisements	-	72,000	144 000	240,000
1.5 Donor funds for institutional support	-	600,000	1,320,000	1,440,000
2 Expenditures	7,386,933	10,130,667	10,016,662	6,907,554
2.1 Operational expenditures	5,481,333	7,134,667	6,750,662	3,301,554
2.1.1 Staff salaries	3,651,025	4,031,520	4,152,360	6 94040
2.1.2 Office maintenance and running costs	1,530,308	1,078,560	1,089,317	1,199,585
2.1.3 Communication costs	-	1,091,083	1,105,555	1,296,000
2.1.4 Transportation costs	-	391,680	403,430	480,000
2.1.5 Other costs	300,000	541,824	581 838	325,969
2.2 Training and meeting costs	-	2,700,000	2,810,000	2,910,000
2.2.1 General Assembly	-	550,000	550,000	550,000
2.2.2 Meeting costs Steering Committee	-	70,000	70,000	70,000
2.2.3 Meeting costs Professional Forums	-	40,000	45,000	45,000
2.2.4 Meeting costs Permanent Committee	-	40,000	45,000	45,000
2.2.5 Training of local government members	-	2,000,000	2,100,000	2,200,000
2.3 Studies	-	200,000	360,000	600,000
2.4 Investments	1,905,600	96,000	96,000	96,000
2.5 Contingency fund (2%)	147,739	202,613	200,333	138,151
3 (Expected) Financial Results	986,208	754,816	1,727,883	7,216,839

1.3 Annual budget

The annual budget should reflect the first year of the multi-annual budget then further break it down in more detailed (financial) data. It is the financial translation of the annual operational plan, reflecting the priorities defined in the strategic plan.

The annual budget is by far the most important financial management tool. However, if not realistic, its usefulness will be rather limited. Realistic means that:

- The budget reflects the priorities of the operational plan;
- The budget is aligned with the strategic plan;
- All activities are included in the budget;
- All revenues and expenditures are estimated based on the best available data, including an analysis of revenues and expenses over the past few years.

During the whole budget process, the following two questions should be asked repeatedly:

- What are the priorities of the association for the allocation of its available resources?
- How does the association expect to raise its revenues?

Once ready, the budget reflects the association's decisions for raising and allocating its resources.

If the estimates are not accurate, the exercise of preparing the budget does not force the association to set priorities. Furthermore, if budget estimates are extremely inaccurate, they fail to act as an effective control on expenditure and on revenue collection. Money is spent with little reference to the association's actual limits and the collection of revenues cannot be compared with realistic targets.

The Finance Officer takes the lead in the budget process. In order to have access to all facts and figures necessary to draw up a realistic budget, a close collaboration with the Executive Director and other staff members, such as the ones responsible for externally funded activities, is essential. The Finance Officer must establish adequate channels of communication with the responsible officers, in order to carry out the financial planning, monitoring and control.

Important considerations to keep in mind when preparing the budget:

- Expenses are more evenly distributed than revenue over time.
- Associations have more certainty on expenses (salaries, rent, electricity bill, etc.) than on revenues (potential membership fees vs. collected fees).
- Revenues should be projected using the best information available, for example the fees collected in previous years (instead of the potential fees), signed agreements with donors and other legal entitlements.
- The timing of the cash flow is also important. Even with a well-balanced budget, the association may face cash shortages if it needs to spend funds before it receives its revenues.

1.4 Budget structure

In essence, a budget is just a numerical statement of expected revenues and expenditures. In order to become more meaningful, the budget should be structured. This structure, called classification, should consider two aspects:

- Functions performed by the association (functional classification). This classification provides information that serves decision-making purposes and shows the allocation of funds among different programmes in response to the strategic priorities. This classification focuses its attention on the services delivered and their relative importance.

A logical *functional* structure for an LGA would be to distinguish:

> Core function (lobbying and advocacy),
> Capacity building activities (training, organ isational development, etc.),
> Other specific programmes, projects and activities (local economic development, research, etc.), and;
> Administrative support.

- Economic categories of expenditure and revenues (economic classification). This classification provides data for accounting, control and accountability. This classification shows the object of the expenditure or inputs.
  > Operational expenditure (consumption, services within the year of purchase),
  - Salaries
  - Stationery
  - Public utilities, etc.
  > Capital expenditure (investment will yield services over the useful life of the assets purchased).
  - Building,
  - Cars, Computers,
  - Software, etc.

Budgets should include all sources of revenues and expenses. Sometimes associations do not include externally (donor) funded projects in their budgets; in such cases the multi-annual budget does not show a comprehensive financial representation of the strategic plan. As a result, donor support tends to be treated as stand-alone activities and not as an integrated part of the association's endeavour to reach its strategic goals. This poses the risks that donors set the association's agenda by pushing their own interest at the cost of the association's strategic priorities. Therefore it is advisable to define all externally (donor) funded support in the strategic plan as well as in the budget.

Associations may decide to apply a more detailed structure by breaking down these main functions into sub-functions. For instance: core business activities can be sub-divided into the association's main functions, services and activities, for example Representation (lobby and advocacy); Service provision; and Communication and dissemination of information. Paid services can be sub-divided into the different types of services.

Externally funded projects can be sub-divided into the different projects, and capital investment plan can be sub-divided into the different investments needed.

Structured in this way, the budget provides a global overview of the financial operations for each of the association's main activities. It enables even non-financial persons, like the Board members and the Executive Director, to get answers to some fundamental questions, such as:

- To what extent are the costs of the association's core function and services covered by membership fees and other structural revenues?
- What membership fees need to be defined in order to become financially sustainable?
- Which of the association's activities are paid for by external contributions, and to what extent?
- What would happen if external support would be reduced or stopped?
- Is the association able to perform its core activities without external support?
- Are the revenue-raising activities profitable? Is it necessary to increase the fees – and if so, to what extent – in order to reach breakeven?

Example 6: Economic and functional classification of budget

Functional classification →

Economic classification ↓

	Lobby and advocacy	Capacity building, training and technical assistance	Local economic develop-ment	Total programmes	Adminis-trative support	Proposal writing and fundraising	Total supporting	Total budget
Revenues	290 000	86 000	404 279	780 279				780 279
- Membership fees	290 000							290 000
- Paid services		86 000						86 000
Externally financed projects - Donor 1			404 279	404 279				404 279
Expenditures	218 150	87 800	402 151	708 101	46 050	23 100	69 150	777 251
- Governing structure								
- Allowances	40 000			40 000				
- Legal & technical support	55 000			55 000				
- Accommodation & meals	55 000			55 000				
- Travel costs	50 000			50 000				
- Other								
Operational expenses								
Salaries								
- Executive director	10 000	10 000	10 000	30 000	10 000	10 000	20 000	50 000
- Programme director		40 000	40 000	80 000				80 000
- Technical staff			195 000	195 000	30 000		30 000	225 000
- Administrative support	7 200	20 000	40 248	67 628		12 400	12 400	80 028
Other operational costs								
- Rent	400	8 000	10 200	18 600	2 500	200	2 700	21 300
- Stationery	500	3 800	6 000	10 300	1 500	--	1 500	11 800
- Public services		1 000	3 333	4 333	1 500	500	2 000	6 333
- Travel costs		2 000	5 000	7 000				7 000
- Other	50	3 000	2 000	5 050	550		550	5 600
Investments			90 190	90 190				90 190
Surplus/Deficit	71 850	(1 800)	2 128	72 178	(46 050)	(23 100)	(69 150)	3 028

Once the functional structure has been established, each function or sub-function should be further structured according to economic categories. An economic classification suitable for LGAs would be:

- Revenues: membership fees, paid services, external support (donor funds, central government funds and other revenues);
- Expenses: governing bodies, staff salaries, office expenses, communication, travel costs, conferences and meetings, and other costs.
- Investments: fixed assets and intangible assets which allow the association to perform its activities.

In the same way as with the functional classification, the economic classification can be further broken down into sub-categories. Although no rule exists for the right level of aggregation or disaggregation, as a rule of thumb, further disaggregation should only be considered if really useful.

2 Control

Once the Board and/or the General Assembly have approved the budget, the Executive Director and the staff are responsible for its implementation. The financial part of this implementation process is to ensure that the financial resources are available on time for planned operations, to control if the actual revenues and expenses are within the budget, and to report regularly to the Board. To be meaningful, these reports should follow the same structure as the budget. Furthermore, they should not only consist of numbers but should be helpful in analysing and explaining the differences between budget and reality, and propose remedial actions if necessary.

2.1 Progress reports and final accounts

Although the Finance Officer can monitor progress on a daily basis, formal progress reports are typically prepared on a monthly or quarterly basis. Quarterly progress reports to the Board should be sufficient, as long as the Finance Officer reports immediately to the Executive Director whenever the accounting system signals major deviations from the budget. (Actually, progress reports should only be prepared for the first three quarters of the year, whereas the final accounts represent the fourth quarterly report.)

For analytical reasons, the reporting format should mirror the budget structure, showing which expenditure figures are out of tune with the budget and need attention.

The difference between progress reports and final accounts is that the latter are comprehensive statements (legally required documents), which include the balance sheet together with income statements and a number of annexes that provide specifications of the balance sheet items, such as Fixed Assets, Debtors, Creditors and balances of Bank and Cash.

For management purposes, the final accounts can be considered as the fourth progress report of the year although it provides more information and will therefore be given more attention. Progress reports and final accounts should not only show numerical differences but, more importantly, the reasons why there are differences. Why do actual expenditure figures deviate from the budget? Is it because of a structural or a one-off event? Is it still possible to make up for the difference and if so, when and how? Based on this kind of analysis, the Board can decide on measures to safeguard the long-term financial viability of the association.

As a rule of thumb, one may assume that quarterly revenues and expenditures are just one fourth of the annual budget. However some expenditures, such as the annual general assembly, are concentrated in one quarter; others, like the staff salaries, are evenly distributed over the year. Some revenues may not be evenly spread over the year, for example the collection of membership fees. Such patterns can only be established by collecting and analysing data over three to five years or more.

Differences between forecasted figures and the actual figures of the budget are called variance.

- Positive variance occurs when forecasted costs are lower than actual cost, and/or when actual revenues are higher than forecasted revenues.
- Negative variance occurs when the revenues are lower than expected, and/or actual costs are higher than forecasted costs.

2.2 Financial registration

It is indispensable for financial management to have systems and procedures in place to ensure that:

- All financial transactions are properly executed and documented (including the measures for the internal control system: “1) provide qualified personnel, rotate duties, and enforce annual leaves/vacations; 2) segregate responsibility; 3) separate operations and accounting; 4) assign responsibility; 5) maintain controlled proofs and security; 6) record transactions and safeguard assets” (Mikesell, 2007));
- Financial statements and reports can be generated;
- The final accounts have to be produced and audited.

2.2.1 Accounting system

A well-designed accounting system must be based on a chart of accounts, which is a comprehensive list including a unique code for all accounts. The list is typically arranged in the order of appearance of accounts in the financial statements. The chart of accounts should be structured and coded according to the economic structure of the budget classification.

Only if the accounting system of the association is structured and classified according to the budget structure, will it be possible to monitor the financial implementation of the strategic plan and to analyse and explain differences between budgeted and actual figures. See also the five functional templates in the Annex of this manual: Core business; Paid services; External funded projects; Capital investment; and consolidated budget.

2.2.1.1 Cash or accrual?

An old proverb says: “Revenue is vanity, profits are sanity and cash is reality”.
The accounting system of an association should be adapted to its actual needs and resources. Smaller associations do not need complicated accountancy systems. They

can keep an accurate record of their cash movements in a cash book; this is called cash-based accounting. It implies that:

- Revenue are recorded when cash is received (by depositing it in a bank account); and
- Expenses are recorded when invoices are paid (by issuing cheques to pay them).

When the association grows and it manages more activities and delivers more services to the members, the revenues increase and, as a consequence, the number of financial transactions increases and becomes more complex.

Then the association is obliged to use a more developed and computerised accounting system, subject to accounting concepts and principles. These systems use accrual basis accounting.

In accrual basis accounting, all economic actions, revenues and expenses are recognised, irrespective of cash transactions.

Incomes are recorded at the moment the association has a right to claim them (e.g. the date when the members have to pay their respective membership fees or when the association has delivered certain services), regardless of whether the association has received the payments (cash).

Expenses are recorded when the obligation is created, for example when new equipment is delivered, salaries are due at the end of each month, or consultants have performed their work – whether the association has paid or not.

Experience shows that even the most sustainable and successful associations in developing countries face problems because an important part of their members are in arrears due to various causes. The use of the accrual basis accounting for the revenue distorts the financial situation, because it shows an artificially high level of income, most of them accounted as receivables that will end up written-off because of the absence of mechanisms to enforce payment. For this reason, the accounting concept of prudence states: 'Revenues and profits should not be anticipated. They should be included only once they are realisable with reasonable certainty.' (Tennent, 2008).

Sometimes it is recommendable to use the modified accrual accounting method. This method registers income on a cash basis and expenses on accrual basis (revenue recorded when cash is received and expenditure recorded when liability incurred); this is a more conservative way for recording income because it considers not only the association's revenues invoiced, but actually received by the association. Expenses are accounted independently if they have been paid following the same concept of prudence: 'It would be wrong to avoid disclosing liabilities or potential liabilities that were known.' (Tennent, 2008).

2.2.1.2 Allocation of costs

Many associations find it difficult to allocate costs to their core functions and services. They tend not to calculate whether individual activities and services are generating or consuming money. Here is an example of best practices:

- The investment plan has budgeted for the purchase of a vehicle to be used for daily activities.
- The budget for the running year shows the total cost of the vehicle and its cost will initially be recorded as an asset on the balance sheet.
- However, the cost of the vehicle will become depreciation expense during its lifespan and as such should be charged to the different functional areas based on predefined allocation criteria.

Some associations put all their costs in a basket without considering specific activities and services. For instance, how much time does the Executive Director devote to a specific activity or service? What are the criteria for the allocation of overhead cost to the various activities and services? What is an acceptable overhead to be charged to a donor for the implementation of a project? What are the actual costs of a training course and how much the participants have to pay for it? How to know if a service is profitable or not?

The costs of an association should be divided into two groups: direct and indirect. Direct costs are those that are clearly attributable to a specific programme/service/activity implemented by the association. For instance: the Programme Coordinator's salary, the cost of renting a venue for a training course, a trainer's fee, etc. The direct costs can be also sub-classified in direct fixed costs like depreciation and amortisation of goods and intangibles of a specific programme; and direct variable costs, for example the number of workdays of specialised advice.

Indirect costs are those that are not easily assigned to a specific programme/service/activity and have to be prorated among them following predefined criteria, for example the salary of the Executive Director, the office rent, the building's security services, public utilities, etc.

All programmes, services and activities have to include part of the indirect costs. This can be done on a case-by-case basis or by defining a unique rate.
The case-by-case method is used in small organisations and permits a more approximate allocation of the costs. For example, it includes keeping records of the telephone calls and the distance covered with a vehicle; using timesheets for the allocation of the time of the Executive Director, secretary, accountant, etc.; or allocating the office rent based on the number of staff employed for each programme, service or activity, or based on the space occupied by the staff employed for each service, programme or activity. The advantage of this approach is the relative accuracy compared with other methods, but the disadvantage is the time and effort needed for keeping the records up-to-date.

The unique rate method normally begins with the identification of all direct and indirect costs; the total indirect costs are then prorated amongst the direct costs. The procedure of allocation is simple and is shown in the example below.

Example 7: Rate of indirect costs (overhead)

Proportional to the direct cost of individual programme, service or activity	**As a proportion of the total direct costs**
Example: The association has a total budget of EUR 5 200 and three programmes with the following costs: Direct costs of programme 1: 2 000 (44.4%) Direct costs of programme 2: 1 500 (33.3%) Direct costs of programme 3: 1 000 (22.2%) Total direct costs of the Assoc.: 4 500 Indirect costs of the Association: 700 • Personnel Administration • Rent • Executive Director • Insurance • Legal services Total costs of programme 1: 2 000 + (700*44%) = 2.311 Total costs of programme 2: 1 500 + (700*33%) = 1.733 Total costs of programme 3: 1 000 + (700*22%) = 1.156	*Example*: The association has a total budget of EUR 5 200 and three programmes with the following costs: Direct costs of programme 1: 2 000 Direct costs of programme 2: 1 500 Direct costs of programme 3: 1 000 Total direct costs of the Assoc.: 4 500 Indirect costs of the Association: 700 • Personnel Administration • Rent • Executive Director • Insurances • Legal services Ratio indirect costs/Direct costs: 700/4 500= 15,6 Total costs of programme 1: 2 000 + (2.000*15.6%) = 2.311 Total costs of programme 2: 1 500 + (1.500*15.6%) = 1.733 Total costs of programme 3: 1 000 + (1.000*15.6%) = 1.156

Sometimes a combination of both methods is suitable, for example if the salaries of the Executive Director and administrative staff are allocated based on the time devoted to each specific programme or service while public utilities are allocated based on the rate of indirect costs.

2.2.1.3 Can an association – as non-profit organisation – have surpluses?

The difference between non-profit organisations and for-profit organisations is what they do with the surplus. For-profit organisations distribute their benefits amongst their owners/shareholders while non-profit organisations reinvest the surplus to benefit the organisation. Consequently, associations can and have to make surpluses in order to ensure their survival and growth.

CASE 4: MAKING ASSOCIATIONS SUSTAINABLE – COMURES CASE

COMURES in El Salvador is one of the most successful associations in Central and Latin America. The payment of membership fees is related to the level of satisfaction and commitment of municipalities with COMURES. The municipal councils decide annually on the amount of their contribution to the association, from 0.2% to 1% of the income they receive as transfers from central government. Currently 80% of the municipalities pay their fee on time.

One of the most remarkable achievements of COMURES is its capacity to fulfil the political mandate of its membership. Even though the most important political parties of El Salvador have an antagonistic position (together they represent more than 80% of the municipalities), they manage to agree on a common municipal agenda beyond partisan interests. Another critical factor is the continuity of the Executive Director who, having been in this position for nearly 20 years, is recognised for great technical skills and an ability to broker agreements with opposing political forces.

The transfer of resources by the central government is guaranteed by law and assures a financial cushion of USD 500 000 per year.

Over time the association has been developing a range of profitable services that allowed it to expand the benefits for its members, while carrying a financial surplus for the past 15 years, which enabled it to establish a financial reserve.

2.2.2 Asset Register

The goal of an asset register is effective preservation, maintenance and protection of an association's property. It provides information that is needed to draw up an adequate balance sheet as part of the annual final accounts.

An association should keep an inventory of all its fixed assets such as buildings, means of transport, computers, fax machines, furniture, photocopiers etc. Usually, fixed assets are items with a useful lifetime of more than one year and a cost price that exceeds EUR 500 per unit. What constitutes fixed assets is to some extent arbitrary. Each association should decide itself on the minimum amount for inclusion in the asset register. Generally, associations have few assets and it would be sufficient to maintain an asset register that provides the following information:

- Description of asset;
- Unique control number as noted on a sticker placed on the item;
- Amount and date of procurement/granting;
- Method and amount of cumulative depreciation (if applied in the accounts);
- Remaining book value;
- Date of disposal;
- Income from disposal (if any).

Once a year, an inventory should be conducted. The disposition of each item must be updated on an inventory control form. It must also be noted on the form whether the association owns the title to the equipment and whether any special conditions apply to the disposition of the equipment at the conclusion of a project, for example if it is donor-funded. The asset register should be verified against the control form.

The association's office should be reasonably secured against theft. Furthermore, all property should be sufficiently insured against loss or damage from fire and theft. All office equipment should be properly maintained. A filing system of warranty information and repair records must be maintained.

2.3 Financial accountability

Although the final accounts are typically prepared by the Financial Officer, in most countries the Board uses them as a legal document to inform the General Assembly, other stakeholders and the public at large on how they have managed the association's finances in the past year. Although many Board members may not have specific financial know-how, they are nevertheless fully responsible for the completeness and correctness of the final accounts.

Many LGAs' statutes mention a Finance Commission in charge of scrutinising the final accounts. This Commission, like the Board, typically consist of persons who are not professionally trained in finance. Therefore, Commission members are not in a position to gauge whether internal control measures are adequate and whether they are properly applied. In some extreme cases, the Finance Commissions have been inactive and do not scrutinise the association's financial systems and procedures at all.

In those cases when the members of the Board and the Finance Commission lack sufficient knowledge to monitor the completeness and correctness of the final accounts, it is advised to subject the document to an external and independent audit. The auditor should be selected via a public tender, whereas related costs should be included in the association's core business budget.

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Annex: Templates for a multi-annual budget (cash basis)

(1) Core Business Budget (in Euro)					
		2014	*2015*	*2016*	*2017*
CODE	OPERATING REVENUES (1)				
1100	Membership fees				
1110	Ordinary Membership fee				
1120	Extraordinary membership fee				
1200	other revenues				
1210	Income from services				
1220	bank interest				
1230	other revenues				
CODE	OPERATING EXPENDITURE (2)				
1300	Governing structure costs				
1310	Allowances				
1320	Board meetings				
1330	Committees meetings				
1340	General assembly				
1350	Other				
1400	Staff costs				
1410	Salaries				
1420	Other staff expenses				

1500	Office Costs				
1510	Office rent				
1520	Security and insurance				
1530	Energy and water				
1540	Maintenance and cleaning				
1550	Office Supplies				
1560	Office utilities				
1570	Other Office costs				
1600	Communication costs				
1610	Advertisements				
1620	Translation				
1630	Bulletin				
1640	Other communication costs				
1700	Travel costs				
1710	Transport				
1720	hotel				
1730	Meals and drinks				
1740	other travel costs				
1800	Other costs				
1810	Auditing costs				
1820	Bank fees				
1850	Contingencies				
1900	CORE BUSINESS RESULT (1-2)				

(2) Paid Services (in Euro)					
CODE		*2014*	*2015*	*2016*	*2017*
2100	REVENUES (1)				
2110	Sales of services				
2200	EXPENDITURE (2)				
2210	Staff costs				
2220	Office Costs				
2230	Communication costs				
2240	Travel costs				
2250	Conferences and meetings				
2260	Other costs				
2270	Contingencies				
2900	RESULT PAID SERVICES (1-2)				

(3) Externally funded projects (in Euro)					
CODE		*2014*	*2015*	*2016*	*2017*
3100	REVENUES (1)				
3110	Donations				
3120					
3200	EXPENDITURE (2)				
3210	Staff costs				
3220	Office Costs				
3230	Communication costs				
3240	Travel costs				
3250	Conferences and meetings				
3260	Other costs				
3270	Contingencies				
3900	RESULT EXT. FUNDED PROJECTS (1-2)				

Remark: The economic categories from both Paid Services (2) and Donor Projects (3) could be further broken down, if needed, in economic sub-categories in the same way as applied for Core Business (1).

(4) Capital Investment Programme (in Euro)					
CODE		*2014*	*2015*	*2016*	*2017*
9100	REVENUES (1)				
9110	Sale of assets				
9200	EXPENDITURE (2)				
9210	Core business				
9220	Paid Service				
9230	Donor Programmes				
9900	NET INVESTMENTS (1-2)				

(5) Consolidated (Multi-Annual) Budget (in Euro)					
		2014	*2015*	*2016*	*2017*
Overall result recurring budget (1)					
1900	Result Core business				
2900	Result Paid Services				
3900	Externally funded project				
Net investment					
9900	Net-investments (2)				
Overall Result/net-Cash Flow (1-2)					

International

This manual forms part of a series produced specifically for Local Government Associations world-wide, whether old or young. The manual is published as part of the Local Government Capacity Programme 2012-2016, implemented by VNG International and financed by the Netherlands Ministry for Foreign Affairs. Other manuals in the series address Establishing an LGA, Communication, Strategic Planning and Service Provision, all activities related to the typical work and context of a Local Government Association.

‘Financial Management in a Local Government Association’ is a practical, easy-reference manual designed to help an LGA to become financially sustainable and to prepare for the budget planning and control cycle. The document is, however, not a blueprint. With the context of each country and specific LGA, approaches will have to be tailored to circumstance.

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