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148. Organisational Ratios-1 Dec'09-Jan'10 Released: Dec '10

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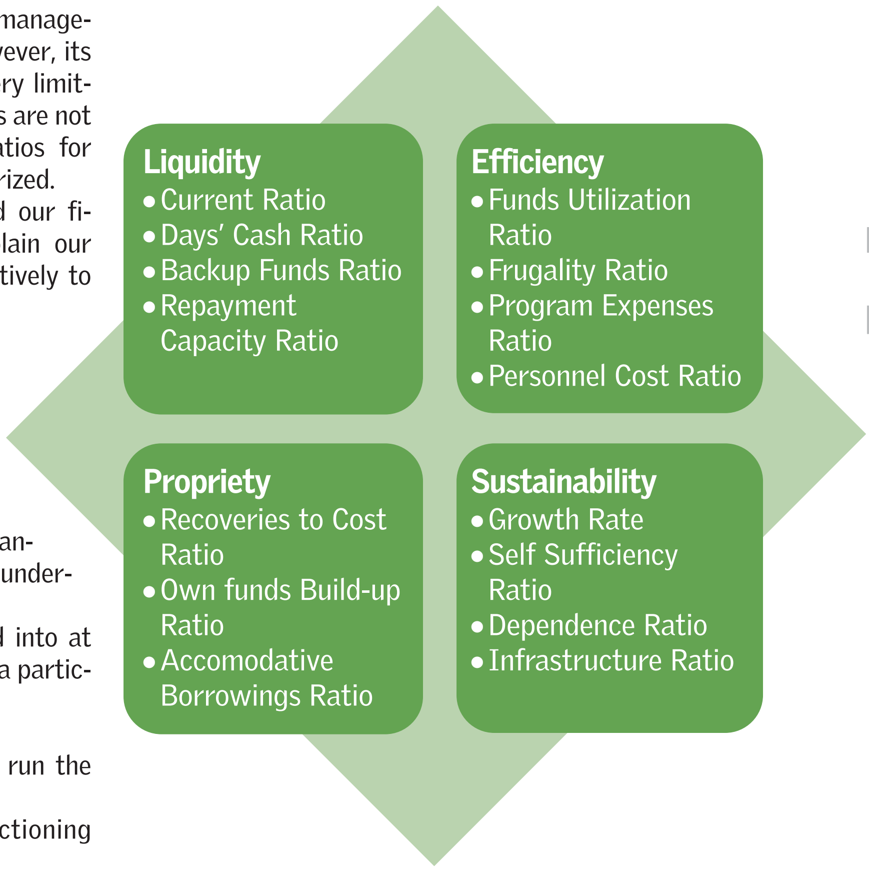
Ratio analysis is a popular financial management tool in corporate sector. However, its use in the NPO sector has been very limited. This is mainly because corporate ratios are not directly relevant. At the same time, ratios for NPOs have not been developed or popularized.

Use of ratios can help us understand our finances better. It can also help us explain our financial needs and priorities more effectively to our donors, supporters and the public.



Classification

For NPOs, financial ratios can be classified into two broad categories:

1. Organisational Ratios and
2. Program Ratios. While organisational ratios look at the entire organisation's financials and health, program ratios can help understand and compare individual programs.

Organisational ratios can be classified into at least four categories, depending on what a particular ratio tells us:

Liquidity: Do we have enough money to run the organisation smoothly?
Efficiency: Is the organisation functioning efficiently?
Sustainability: Is the organisation sustainable in the long run?
Propriety: Is the organisation's financial behaviour proper and ethical?

Liquidity Ratios

Running out of cash is a frequent problem that many NPOs face. Mostly this happens due to delays in disbursal of funds. But lack of sufficient operating capital is also a key factor. Liquidity ratios can help us understand how likely are we to face this kind of problems. Once we know this, we can take steps to prevent this from happening repeatedly.

Current Ratio

The current ratio gives you an idea whether you can meet your short term liabilities easily. This ratio compares two items. One is current assets. This consists of cash and other assets which will turn into cash within one year (bank, short term deposits/ investments, grants receivable, loans and advances, etc.).

The second item is current liabilities. This consists of liabilities that will become due within one year (sundry creditors, salary payable, grants payable, provisions for expenses, loan instalments due within one year, etc.)

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It is often easy to pick these items from your balance sheet, if the accounts have been presented well. Once you have these figures, use the following formula:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

In the for-profit and government sectors, a current ratio of 2:1 is considered an indicator of reasonable financial strength. This value is probably as relevant for NPOs as well. A ratio of less than 1.0 indicates that the organization does not have sufficient current assets to meet current payment obligations.

However, one peculiar problem that NGOs might face is restrictions within the current assets. For instance, funds for one project cannot easily be used for another project. Similarly, the Indian and Foreign Funds cannot be used inter-changeably. Therefore, it may be useful to assess liquidity separately for FCRA and Indian funds.

Days' Cash Ratio

Imagine that for some reason you stop receiving fresh funds. How many days can you run the operations normally in this situation? This is what the Days' Cash Ratio tells you.

To calculate this ratio, you need to know the cash and bank balances. To this you can also add bank deposits, if these can be broken on demand. Project advances and salary advances can be included. However, personal advances to staff should not be included. The resulting figure is divided by your annual operating expenses, as given in the Income & Expenditure Account. This would include your program expenses and administrative expenses, but not depreciation.

$$\text{Day's Cash Ratio} = \frac{\text{(Cash + Cash Equivalents)}}{\text{Annual Operating Expenses - Depreciation}} \text{ X 365}$$

How many days' cash should you keep? This could vary from one organization to another. However, generally, an organization should have enough cash/ bank balance to last for at least 90 days.

Please keep in mind that here cash does not mean currency notes alone. By cash, we mean cash in hand as well as in bank.

Backup Funds Ratio

What happens if you run out of cash? You can fall back on your reserves and investments made from unrestricted funds. This ratio tells us how many days can we survive on emergency

funds. To work this out, we just need the figure of investments which can be encashed in case of emergency.

These could be mutual fund investments, government securities, bonds etc. Fixed deposits with banks should not be included here, as these are treated as cash equivalent. Normally these would be investments against unrestricted funds. If you have a nominal corpus[1], then investments made against these can also be added.

$$\text{Backup Funds Ratio} = \frac{\text{Encashable Investments}}{\text{Annual Operating Expenses - Depreciation}} \text{ X 365}$$

If this ratio is too high, it may imply that we are holding up public funds for an emergency that may never occur. On the other hand, if the ratio is too low, it may mean that the slightest hitch will upset our program activities. So probably a ratio of 60-90 days will work for most NGOs. Do keep in mind that this cushion is in addition to the one provided by Days' Cash Ratio.

Repayment Capacity Ratio

The main reason for collapse of the housing loan market in USA in 2008-09 was low repayment capacity. People who had borrowed money to buy houses did not have enough income to repay these in time. This set off a chain of events - the world economy has yet to recover from the shock.

Fortunately, most NGOs do not face this problem because banks don't usually give loans to NGOs. However, some organisations, especially in the micro-finance sector do borrow funds. Will they be able to repay the loans on schedule? The Repayment Capacity Ratio

[1] AccountAble 67: Corpus. www.AccountAid.net

helps us understand this.

$$\text{Repayment Capacity Ratio} = \frac{\text{Own Funds}}{\text{Total Borrowings}}$$

Total borrowings include Borrowings from banks, Loans from management/ employees/ key persons etc. Own funds are essentially unrestricted funds. These may include corpus funds, funds accumulated from income generation activities, general donations, miscellaneous income etc.

What happens if an NGO has borrowed more than it can repay? There is a risk that it might start delaying implementation of projects, and use the grant funds to repay loans.

Efficiency Ratio

Once we have taken care of our liquidity, we turn to another important question: How efficient are we in using the resources that we raise from public and grant-making agencies? The efficiency ratios help us look at this from several angles.

Funds Utilisation Ratio

The ability of an NGO to use the available funds for its mission is an important consideration. Most grant-makers worry that the NGO will sit on their funds rather than use it. Similarly, the Governments design tax exemption schemes for NPOs based on their spending[2]. The formula for this ratio is:

$$\text{Funds Utilization Ratio} = \frac{\text{Money Utilized}}{\text{Money Received}} \times 100$$

Calculating the ratio is rather simple, if the Receipts and Payments Account is available. You need to simply pick up the funds received during the year from the Receipts side. Compare these with the funds utilized, as given on the Payment side. Remember that you must include the purchase of fixed assets in the utilization figure. However, non-program advances and loans should usually be excluded.

In the Indian context, this ratio would range from about 85-100%, as an average, over 2-3 years. In a particular year, the ratio may dip or increase significantly. This may occur because a large grant was received towards the end of a financial year. This money would be utilized in the following year. Similarly, if you receive a multi-year grant in the first year, the ratio will be unfavourable in that year, but will become better in later years.

Frugality Ratio

It is generally believed that NPOs should spend as little as feasible on their own administration. This ratio shows how much an NPO spends on administration as compared to the overall expenditure.

$$\text{Frugality Ratio} = \frac{\text{Admin. Exp.+ Purchase of office assets}}{\text{Total Funds Utilized}} \times 100$$

What are administrative expenses? This can lead to heated arguments and confusion. Mostly costs such as rent, electricity, stationery, telephone, salary of administration staff, accounts department, board meetings, office overheads, etc. are considered asadministrative expenses. Part of the Chief Functionary's salary should also be considered as administrative expense. Assets purchased during the year for administration or office should be added.

Total funds utilized would include all the expenses of the organization i.e. program, administrative, fundraising etc. Purchase of assets during the year, whether for office or programs, should be added to this.

How much should this ratio be? This is another vexing question. The answer depends on what is treated as administration. If the suggestion given above is accepted, then administrative expenses would usually range from 10-15%. However, if all salaries (including program staff) are considered as administrative expenses, then this ratio could go up to as much as 60-75% in many cases. This is particularly true for NGOs working on awareness or advocacy programs, which usually requires a significant number of staff. As against this, the FCRA Bill 2010 has laid down a limit of 50%.

Programme Expenses Ratio

This is the flip side of the frugality ratio. It tells us about the proportion of funds spent on program activities.

$$\text{Programme Expenses Ratio} = \frac{\text{Direct Program Exp. + Purchase of Program Assets}}{\text{Total Funds Utilized}} \times 100$$

Direct Program Expenses are expenses directly associated with a particular program/activity. Assets purchased for use

[2] For instance, in India, the exemption is based on fulfilling the minimum spending requirements, which is currently 85% of revenue, but is likely to go up effectively to 100% next year. In the US, NPOs are required to distribute 5% of their net assets each year to remain exempt from tax.

in programs or for distribution in the community should be added.

This ratio would normally range from 80-90% for implementing NGOs. If the NGO is also raising funds from the public, then fund-raising costs could bring this down.

Personnel Cost Ratio

This ratio tells us how important human resources are for an organization's work. It helps us understand how much the organization is spending on its personnel in relation to its total cost.

$$\text{Personnel Cost Ratio} = \frac{\text{Personnel Cost}}{\text{Total Cost}} \times 100$$

Personnel Cost includes salary and benefits paid to the employees. Benefits would include any allowances or perquisites paid to the employees. In some cases, contractual employees may be treated as consultants. Their fees, apart from fees/ expenses for volunteers should also be considered as personnel cost.

How much should this ratio be? There is no simple answer to this. It depends on the type of program taken up by an organization. For instance, an NGO running NFE schools could be spending as much as 80% of its funds on teachers' and program staff salaries. Same is the case with research or advocacy organizations, which may spend 40-50% on salaries. On the other hand, an NGO installing hand pumps might spend just about 10-20% on staff costs. Further, in real life, most NGOs take up several different kinds of activities - this makes it difficult to lay down norms for this ratio.

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