AccountAble™

NGO Accounting — Issue # 89; Mar-03; Released: Aug - 03

In this issue

Recently, there has been increased interest in NGO accounting and related standards. This paper discusses some of the issues related to setting standards for NGO[1] accounting.

Objectives of NGO Accounting

Why do NGOs maintain accounts? There are several reasons:

- To know how much money they have received and spent in a year. Also to know how much unspent funds they have, and how these are kept.
- To ensure that funds are spent / utilized properly for objectives of the organisation.

- To provide financial reports to donors, Government and public.

Business organisations also maintain accounts for similar reasons. However, there is one very important difference: at the end of each year, owners of the business want to know how much profit[2] they have made. This helps them decide how much of the profit they can take out as dividend.

This key element is completely missing in NGOs. All NGOs are barred[3] from declaring dividends or distributing profits to their 'owners'.

Profit & Loss vs. Income & Expenditure

This is also clear from the title of the annual financial statements for the two. The Balance Sheet is called by the same name for business organisations as well for NGOs. However, when it comes to the operating statement, the titles are quite different.

Profit & Loss Account

Business organisations prepare a Profit & Loss Account each year. This shows the profit or the loss for the year[4]. As observed earlier, business-people are very interested in this.

[1] In USA, these organisations are called NPOs or not-for-profit organisations. This helps US organisations to distinguish themselves from the main activity of US: profit-making.

On the other hand, in India, these are commonly called NGOs or non-Governmental Organisations. This perhaps shows how the NGOs emerged as an alternative to Government action, which pervaded the nation from 1950 to 1990.

[2] Or loss

[3] By their constitution, common practice and the law. NGOs also can not distribute surplus assets to their members on winding up.

[4] Perhaps the Profit & Loss Account should really be called Profit *or* Loss Account.

Income & Expenditure Account

Following the same reasoning, NGOs should prepare Surplus & Deficit Account. However, this is not the case. NGOs prepare Income & Expenditure Account instead. Why?

Well, simply because generating a surplus is not the main objective of an NGO. The Income & Expenditure does show a surplus[5] or deficit. However, this is just like a byproduct.

Most NGO functionaries will not be able to tell you how much surplus or deficit they had last year. On the other hand, businesspersons will be able to rattle off profit figures[6] for last several years.

Audit Statement

The standard audit report for business organisations also emphasizes this. When commenting on the Profit & Loss Account, the auditors write as follows:

> "…in our opinion, the said accounts give a true and fair view:…
>
> ii. in case of the Profit & Loss Account, of the profit of the Company, for the year ended on that date."

Now a question arises: how should the audit report for an NGO be worded? Should we replace the word 'profit' with the word 'surplus'?

We could. But NGO functionaries are not really interested in the figure of surplus – it doesn't have any significance for them. Neither is it relevant for the income tax officer or donors. So why should the focus of the audit be on a figure which is really irrelevant[7] for NGOs.

An alternative approach for the auditors would be to comment on the amount of the income and the expenditure during the year. The audit report for an NGO may then look as below:

> "…in our opinion, the said accounts give a true and fair view:…
>
> ii. in case of the Income & Expenditure Account, of the income and the expenditure of the Society, during the year ended on that date."

What about the Balance Sheet?

At present, there is not much difference between the business Balance Sheet and the NGO Balance Sheet. So perhaps the same wording would suffice.

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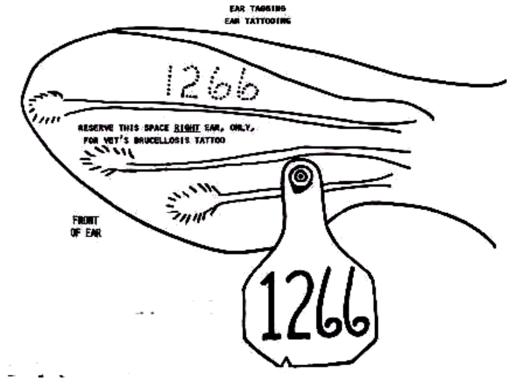
[5] Strictly speaking, this should be called 'Excess of income over expenditure'. For convenience, we have called it 'surplus'. The correct title further reinforces the argument, that NGOs are not interested in generating a surplus.

[6] Not just one figure of profit – business persons have a whole set of figures: gross profit, net profit, cash profit, profit before interest and tax (PBIT), Earnings per share (EPS), profit percentages, graphs, charts, …. There seems to be a clear case of *philoprofity* here!

[7] In fact, profit-making is so irrelevant for NGOs that many prefer to call themselves NPOs (not-for-profit Organisations).

Fund-balances

However, an important element of some NGO Balance Sheets is the existence of ear-marked[8] funds. Such funds are set aside for spending on a specific project or in a specific area[9]. These funds are shown on the liabilities side of the Balance Sheet.



[8] The term ‘ear-marked’ was first used for funds reserved for a specific purpose in the 19th century AD.

The concept comes from the ancient practice of marking cattle ears with a tag to indicate ownership. With commercialization of dairy-farming, this callous practice is now finding takers even in India.

In some countries, the practice was followed for humans also. According to the Holy Bible (Exodus 21), if a Hebrew servant did not want to go free after six years, then his Israelite “master shall bring him unto the judges; he shall also bring him to the door, or unto the door post; and his master shall bore his ear through with an [awl]; and he shall serve him for ever.”

[9] Ear-marked funds can be sub-divided into two categories: 1. Designated funds (set aside by the managing body from NGO’s own funds), and, 2. Restricted funds (restrictions imposed by the donors). For more on the difference between designated and restricted funds, see ‘Technical Guide on Accounting and Auditing in Not-for-Profit Organisations’, ICAI, 2003.

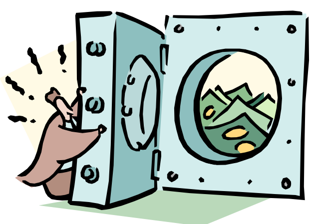
Balance Sheet as at 31-3-03

Liabilities	Rs.’000	Assets	Rs.’000
General Fund	100	Buildings	70
Earthquake Fund	200	Fund Investments	700
Education Fund	500	Other assets	25
Other liabilities	10	Cash & Bank	15
Total	810	Total	810

In the Balance Sheet shown above, the Earthquake Fund and the Education Fund are ear-marked funds. The Earthquake Fund will be spent on activities related to Earthquake relief or rehabilitation. Similarly, the Education Fund will be spent on education.

The terms earthquake or education are merely used as short titles. These funds may have been set up by the NGO itself. In such a case, the resolution of the Governing Body will have more details on use of these funds.

Alternatively, these may be from a grant by one or more donors. In such a case, the agreements with the donors will say what exactly these funds should be used for.



Ear-marked funds should be represented by corresponding assets on the Assets side of the Balance Sheet. In this case, we see fund investments of Rs.700,000 on the assets side. These investments cover the value of both the funds.

Audit Statement

Sometimes this does not happen and the investments[10] are used up for some other purpose[11]. The standard audit report also does not cover this.

Auditors could, therefore, think about modifying the audit report as follows:

> "…in our opinion, the said accounts give a true and fair view:
> i. in case of the Balance Sheet, of the state of affairs, including the fund-balances and corresponding assets, of the Society as on 31st March 2003."

Value-addition

This approach could also add further value to audit, so far as the NGO is concerned.

Firstly, it would help the NGO look at this more carefully. NGOs would then be able to set up separate funds, track their value, and monitor related income and expenditure[12]. This will help them plan long-term projects, and nurture resources required to implement these.

Secondly, it would reassure donor agencies that their grant funds are being tracked separately. This would also encourage donor agencies to provide long-term grant funds, secure in the knowledge that the NGO has proper fund-accounting procedures.

[10] Against the ear-marked funds

[11] Or there may be a drop in market-value of the investments.

[12] A good example is fund-raising with approval under section 35AC of Income Tax Act, 1961. Under the accounting norms for this, approved NGOs must track the total income, expenditure and balance of this fund constantly. This can be done quite simply by setting up a fund called 'Project XYZ Fund (35AC)' and following fund-accounting procedures.

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