AccountAble™

Basis of Accounting **Issue # 90; Apr-03; Released: Aug - 03**

In this issue

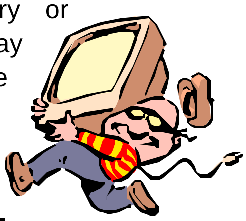
What should be the basis of accounting[1] for an NGO? There are three possibilities: 1. Cash basis, 2. Accrual basis, and 3. Mixed basis. Most NGOs choose cash or mixed basis. Some have now started following accrual basis also.

The Three common bases

Which of these is better for NGOs? Let us see the assumptions behind each of the bases:

1. Cash Basis

Cash basis is useful when there is general uncertainty about recovery or payment of funds. This may happen in areas where the law and order situation is bad. Or it may happen in times of war or other natural calamity. In such a situation, traders also stop making credit sales.



In some cases, the nature of the 'business' may be such that you cannot sue for recovery. An example is that of a fence dealing in stolen goods.

Smaller businesses often do not have access to credit and do not carry large inventories. Here cash basis of accounting is more convenient.

Cash basis is a little less complex than accrual accounting. It is, therefore, also advisable where an organisation does not have a trained accountant.

2. Accrual Basis

In the present business world, accrual or mercantile accounting is almost universal. Modern businesses use credit in many complex ways. This means that there can be a long delay between a transaction and receiving of cash for it. Similarly, capital-intensive businesses must also write-off their plant and machinery over a period of time.

Sometimes accrual accounting lends itself to serious misuse. It allows clever accountants to manipulate financial results in many ways. From one point of view[2], it became easier for people to inflate earnings of Enron, WorldCom, Xerox, etc. by misusing accrual accounting.

3. Mixed Basis

Mixed basis is also called modified accrual basis. It combines a little bit of both: cash as well as accrual.

For example, expenses may be recognized on accrual basis. Grants and recurring income (rent, interest, etc.) may also be recognized on accrual basis. But donations may be accounted only when received.

The extent of mixing cash and accrual may vary from one organisation to another. This is normally clarified through notes to accounts.

1 'Basis of Accounting' determines the time when you would record an income or expense: when it becomes due or when it is actually paid or received. For more on this, see AccountAble 59: 'Commonly Confused Terms'.

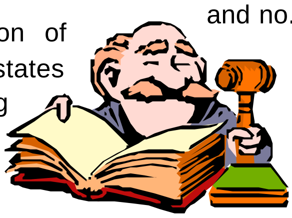
2 Mr. John Cassidy offers an interesting historical perspective on the link between executive compensation and business accounting in 'The Greed Cycle'. Pp. 64-77, The New Yorker, September 23, 2002

Legal Requirements

What does the law say about this?

Societies Registration Act, 1860

The Act is silent on the question of counting. Similar laws in other states have some provisions covering counts. However, none of state Acts prescribe any basis of accounting.



Bombay Public Trusts Act, 1950

This is applicable in Gujarat and Maharashtra. The Act does not lay down which basis of accounting should be followed. However, a format of Balance Sheet and Income & Expenditure Account is given in the rules[3].

The format shows that both accrual and cash basis is acceptable under the law. Further, accrual basis is visualized mainly for rent and interest income. There is no requirement of following accrual for donations or grants.

If the accounts are kept on cash basis, then outstanding income at end of the year is shown through a note in the Balance Sheet.

Companies Act, 1956

This Act applies to non-profit companies, which have a license under section 25. Such companies have to maintain accounts on accrual basis, just as other for-profit companies[4].

Income Tax Act, 1961

Income Tax Act lays down the basis of accounting for certain types of income in section 145. These provisions cover organisations, which have income under the head 'profits and gains of business or profession', or have 'income from other sources'.

Such organisations have to follow either mercantile (accrual) or cash basis of accounting[5]. This basis should be followed consistently from year to year. Also, no mixing of the two systems is allowed.

Do these provisions apply to NGOs? Yes and no. The provisions apply to the extent an NGO has business income or income from other sources[6]. These would not apply to ry contributions[7] or to income from trust assets.

If this view is accepted, then NGOs are free to choose a mixed basis of accounting for most of the activities related to grants or donations.

However, for their business-type activities[8] or for income from other sources, they must follow either cash or accrual basis.

FCRA, 1976

The Foreign Contribution (Regulation) Act, 1976 bypasses the question of cash or accrual. Under the FCRA rules[9], NGOs have to file a Receipts & Payments Account each year. As the Receipts & Payments Account is always on cash basis, the question of accrual accounting becomes irrelevant.

So what's best for NGOs?

We can divide NPOs in two broad categories for this discussion:

1. Organisations that provide services to people (hospitals, schools, colleges, etc.). These are mostly run on fees received from users. Donations form a small part of their income. We have termed these as NPOs.
2. Organisations, which run programs supported by grants or donations. Fees form a small part of their income. These are commonly called NGOs.

[3] Schedules VIII and IX

[4] Section 209(3)(b)

[5] Section 145, Income Tax Act, 1961

[6] This includes items such as dividend, interest, hire of equipment, royalty, lottery winnings, etc.

[7] As defined in section 2(24)(iia), read with section 11(1) and section 12(1)

[8] NGOs have to keep separate account books and prepare a separate Profit & Loss Account for this type of activities. Section 11(4A)

[9] Rule 8(1)(b), read with sub-rule 2

Let us now look at key features of NPO / NGO financial environment:

Firstly, an NGO can not enforce a promise to donate. What does this mean?

Let us say that Mr. Singh is overcome with emotion at a charity dinner. He makes out a cheque for Rs.Ten lakhs and hands it over to you on the spot. Three days later, the cheque comes back to you, unpaid.

Living in the future: Accounting for promises

In USA, a 'promise to give' is commonly called a pledge. In a literal sense, a pledge is more solemn than a promise. Legally, a pledge of contributions may or may not be enforceable. In any case, no fund-raiser would probably ever think of going to court over an unfulfilled pledge.

All unconditional pledges must be recorded in the accounts (SFAS 116). This means that a promised donation is more or less treated as a debt. The income of the NGO for the current year goes up accordingly.

However, SFAS 116 makes two allowances:

1. An allowance for un-collectible pledges. Typically, NPOs estimate from their past experience how much of the pledged amount may not be collected. They show this as a reduction from the 'pledges receivable' in the Balance Sheet.
2. A discount for present value of money. Money receivable in future is discounted to present value, using a suitable interest rate. The 'pledges receivable' are shown at the discounted value.

Living in the future? No, merely accounting for it.

Can you sue Mr. Singh? No. Under current Indian law[10], a promise to donate is an unenforceable contract, as it is a contract without consideration[11].

Secondly, NGOs do not store significant costs or value in items such as inventory or debtors. They also do not have large volumes of depreciable fixed assets.

However, NPOs (such as hospitals) differ from NGOs in this. They often have large stores as also expensive equipment and machinery.

Thirdly, credit transactions at NGOs are very limited. They also do not avail credit facilities with banks etc.

NPOs (such as hospitals and schools) do not provide any significant credit to the users of their services. However, NPOs may take supplies on credit or may have taken loans from banks etc.

Fourthly, the control environment at most Indian NGOs is in early stages of evolution.

In such a situation, mixed basis of accounting may be most appropriate. Here also, we could choose different combinations for fee-based NPOs and grant-based NGOs.

Item	NPOs	NGOs
Fees	Accrual	Accrual
Income from rent, interest, dividend, etc.	Accrual	Accrual
Govt. subsidies	Accrual	Accrual
Project Grants[12]	Accrual	Accrual

[10] This was not always so. According to Acharya Chanakya's *Arthashastra* (composed in 15th century BC or 2nd century BC), donated money could be recovered in the same way as a debt. [3.16.1]. dÄSyaàdanm [adann VyaOyatm , P. 322, *Kautileeyam Arthashastram* , Chaukhamba Vidhyabhavan, Varanasi, 4th Edition, 1996

[11] Indian Contract Act, 1872. The Act is based on English law.

[12] Project grants are normally formalized through enforceable agreements. An NGO has the legal

Item	NPOs	NGOs
Donations	Cash	Cash[13]
Expenses on salaries, rent, interest, etc.	Accrual	Accrual
Other Expenditure	Accrual	Cash

Other expenditure by NGOs

In the table above, the accounting basis for 'Other Expenditure' by NGOs is shown as cash.

This would include most non-recurring program expenditure. It would also include other administrative expenditure. You may wonder why this should not be kept on accrual basis?

Firstly, shifting this to accrual basis would increase the accounting complexities.

Secondly, unscrupulous accountants can also misuse[14] it. This will harm the reputation of NGO sector and will thus stifle its growth.

Disclosure

Whichever basis you follow, it is best to disclose it in the accounts. This is done through a note describing the basis of accounting.

For instance, if you are an NGO, which decides to follow the basis shown in the table above, you could give a note like this:

> "The Accounts have been prepared on accrual basis except for donations and other expenses, which are accounted on cash basis.
>
> By other expenses, we mean non-periodic expenses, including most of the program and administrative expenses. Other expenses do not include period-based expenses such as salaries, rent, interest, etc."

There is no need to quantify the financial impact of the above policy, if the same policy is followed consistently from year to year.

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7: Your Accounting Policies

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89: NGO Accounting

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right to recover these once a funding-agency has signed an agreement, and the NGO has fulfilled the necessary conditions of the grant agreement.

13 It can be argued that this is really accrual basis only. How? Donations are being accounted when actually received. This is coincident with the time when a legal right arises to receive them. Therefore, you are accounting for them at the time when the donations become due.

14 They could make entries for provision of fictitious expenses at the end of the reporting period. These would be accounted, audited and reported to the concerned donor agency. After the reporting, these entries may sometimes be simply reversed. Thus, large amounts may get siphoned out by the organisation.