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What should be the basis of accounting¹ 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 inven-

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.

tories. 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 the 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 view², 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.

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

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.



The Asian Situation

When it comes to NPO accounting, people often look to USA for guidance. In USA, accrual basis of accounting is the norm for medium and large-sized NPOs. However, most of the smaller NPOs continue to use the cash basis of accounting. Accrual basis also makes sense if you want to account

for donation pledges (see box: Living in the Future...). What is the position in Asia?

The practices and prescriptions vary from one country to another:

1. Bangladesh

The NGO Affairs Bureau has not laid down any guidelines regarding this. Most of the NGOs use cash basis of accounting. Some use mixed basis of accounting, following the principle of conservatism (income on cash basis, expenses on accrual basis).

2. China

Effective 1-January-2005, accrual accounting is compulsory for all registered NPOs in People's Republic of China³.

3. Hong Kong

NPOs in Hong Kong are required to use accrual basis⁴.

4. India

Most of the NGOs use cash basis of accounting. The Institute of Chartered Accountants of India has recommended accrual basis in a recent Technical Guide⁵.

Non-profit companies have to follow accrual basis by default⁶. NGOs having business activities are required to choose either accrual or cash basis⁷.

5. Indonesia

Most of the NGOs use mixed basis of accounting. However, larger NGOs tend to use accrual basis.

6. Pakistan

Cash basis of accounting is used by most NGOs.

³ Article 7, Accounting Standard for NPOs, issued by Ministry of Finance, PRC, September 2004

⁴ Hong Kong Institute of Certified Public Accountants

⁵ Para 3.22, page 29; Technical Guide on Accounting and Auditing in Not-for-Profit Organisations. Feb-2003

⁶ Section 209(3)(b), The Companies Act, 1956

⁷ Section 145, Income Tax Act, 1961

7. Philippines

Accrual basis of accounting has been recommended as the norm by a Task Force⁸. Smaller NGOs may be allowed to use cash basis during the year and convert the financial statements to accrual at the year end.

8. Nepal

Cash basis of accounting is commonly used.

9. Sri Lanka

Most of the NGOs use cash basis of accounting.

10. Thailand

NGOs are using all three bases of accounting: cash, accrual and mixed. There is no specific direction for a particular basis.

So what's best for NGOs?

We can divide NGOs/ 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.

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

Firstly, in most countries⁹, an NGO can not enforce a promise to donate. What does this mean?

Let us say that Mr. Singh becomes emotional at a charity dinner. He makes out a

⁸ Para 10, Proposed Statement of Financial Accounting Standards for NGOs in the Philippines, 2004

⁹ In USA, this varies from one state to another. In some states, you can sue if a donor does not follow-through on his or her pledge. However, in practice, most charities avoid getting into lawsuits over this.

cheque for Rs.Ten lakhs and hands it over to you on the spot. Three days later, the cheque comes back to you, unpaid.

Can you sue Mr. Singh? No. In most Asian countries¹⁰, a promise to donate is an unenforceable contract, as it is a contract without consideration¹¹.

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 regard. They often have large stores as also expensive equipment and machinery.

Thirdly, credit transactions in 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 loans from banks etc.

Fourthly, the control environment at many Asian 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, in-	Accrual	Accrual

¹⁰ This was not always so. For instance, in India, 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]. दत्तस्याप्रदानमृणादानेन व्याख्यातम्। P. 322, *Kautilleeyam Arthashastram*, Chaukhamba Vidhyabhavan, Varanasi, 4th Edition, 1996

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

Item	NPOs	NGOs
Interest, dividend, etc.		
Govt. subsidies	Accrual	Accrual
Project Grants ¹²	Accrual	Accrual
Donations	Cash	Cash ¹³
Expenses on salaries, rent, interest, depreciation 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 misuse¹⁴ it.

¹² Project grants are normally formalized through enforceable agreements. An NGO has the legal 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 they are actually received. This is co-incident 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. This situation is all the more likely as NGO auditors often do not have

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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