# OVERVIEW OF FINANCIAL MANAGEMENT OF NPO'S

CERTIFICATE COURSE

**IN FINANCIAL MANAGEMENT & ACCOUNTABILITY**

CPA SERVICES

*(MODULE - I)*

# CONTENTS

# Chapter 1

## 7 Steps Of Effective Financial Management

Financial Management is management of finance i.e. money and other resources or factors. The resources include Human resource, Assets/equipment, Material and money. The way the money is utilized and benefit is derived shows the financial management capability of an organisation. In the chapter, the significance and various elements of the Financial Management System are discussed.

The way we should manage our finances would be better known when we know who we are accountable to. The NGO is not accountable to any specific person or the group of people. Since it handles the public money, it is accountable to the general public at large and so its primary accountability is towards the public at large. It includes all possible stakeholders and so the NGO has huge accountability.

Stakeholders of an NGO and their accountability:


To be very specific and know as to whom we are accountable to as an NGO we need to define our stakeholders. Stakeholders of an NGO include Funding partners or Donors who fund the development project. It includes the government who regulates through the Law of Land. The NGO is also accountable towards its governing body. But the major accountability of NGO is towards its direct beneficiary and the public at large. This shows the magnitude of accountability that an NGO needs to have.

So Financial Management can be defined as optimum utilization of resources. Money gives return the way it is utilized. The value that the money gives is derived from its use rather than its denomination. The money when used in the best possible way gives the best result and that is the optimum utilization and value for money. In the same way, all available resources should be used in the best possible way to carry out the planned activity so that the objective of the activity and overall objective of the project is achieved i.e. obtaining the value of activities.

As we have seen, the reason for the high accountability standard requirement of NGOs is because of wider stakeholders an NGO is accountable to. When we compare the accountability of an NGO with that of a limited company, we would see that the primary accountability of a company is towards its shareholders. It also has a degree of accountability towards other stakeholders like creditors. However, the domain of its accountability is quite small and limited in relation to an NGO which when seen on a larger caravan brings out its accountability towards the public at large including everyone.

Another parameter on which a company can be compared with an NGO is the basis on which their performance can be judged. If a corporation has earned profit in a year i.e. the income is greater than expenditure, we can say without doubt its governing body. But the major accountability of NGO is towards its direct beneficiary and the public at large. This shows the magnitude of accountability that an NGO needs to have.

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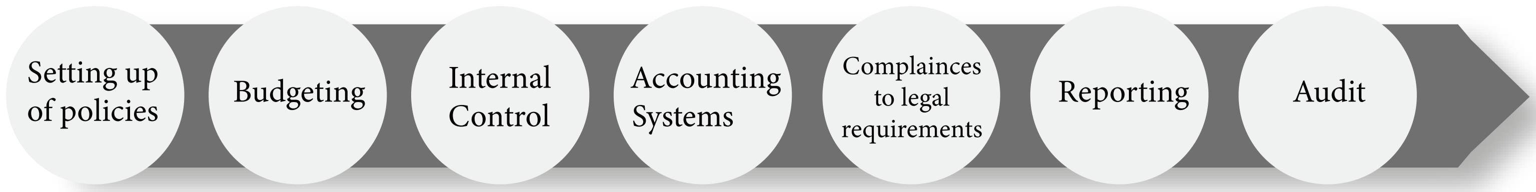
Another parameter on which a company can be compared with an NGO is the basis on which their performance can be judged. If a corporation has earned profit in a year i.e. the income is greater than expenditure, we can say without doubt that the corporation is doing well. When the profit of a corporation increases, we can very well say that its performance is better than in the past. Is this interpretation true for an NGO? Can we say whether the performance of an NGO with surplus of income over expenditure is better or of the NGO with excess of expenditure over income. To judge the performance of an NGO we need to see into actual implementation of the work, i.e. activities viz a viz the plan. Surplus or deficit does not give much information about the performance of the NGO.

However, it is not possible to define the financial management in a closed domain, it is always better to define it distinctly as to its applicability to an organisation. An organisation depending upon its size and need can build its financial management system and include relevant facets to optimize the utilization of its resources. Broadly there are 7 steps to build an effective Financial Management System. These all together constitute the overall framework for an efficient Financial Management system.



## 1.1 Setting Up Policies

Setting up of policies is the foundation of the logical systematic edifice of an organisation. It guides the formulation of the Standard Operating Protocol (SOP) of the organisation. It is formulated keeping in mind the nature of organisation and check and balances required to safe-guard its assets and other resources. Broadly an organisation should have Finance policy, Human Resource Policy, Asset Policy and Administration Policy. However, an organisation can have other policies related to various matters. Some of the policies are very crucial for effective Financial Management system; they are policy related to;

- Method of Accounting
- Cash Payment
- Procurement
- Travel
- Salary
- Leave
- Investment

## 1.2 Budgeting

Budgeting is another aspect which is very important for monitoring the actual performance or the implementation of the project. Budget is even more important in an NGO's context as almost all the projects have a fixed budget which in general of course doesn't change. The actual work of an NGO is much guided by a Budget along with its activity plan. A well formulated budget gives a very clear direction to the work. It also works as control for the actual implementation of the project. We would discuss the budget and budgetary control in detail in module 3 specially designed for that.

## 1.3 Internal Controls

An organisation is formed by people working there who use the resources to achieve the objective of that organisation. When people work in a group, it is imperative to have checks and balances that would safeguard the resources of the organisation. This is done by imputing checks and balances in the system in the organisation.

One person should not be given authority to carry out a transaction or work from its inception till end. There should be a fair segregation of duties so that the work done by one is cross checked by others to avoid any chance of intentional or unintentional errors.

## 1.4 Accounting Systems

The base of good Financial Management is its accounting system. Accounting system starts with systematically recording the financial transaction and ends with presenting the state of affairs in the financial reports. The entire system should have been made to carefully record the transaction to present the quantitative picture of work being done by the organisation. This would give an idea as to how the resources of the organisation are being utilized. An NGO accounting system presents actual financial data that when compared with the financial plan gives information about the actual picture of the project implementation. Good and robust accounting system helps management to have information to keep the implementation on track. Accounting system, as said earlier, also produces a financial statement that provides a window to other stakeholders to look into the financial affairs of the organization.

## 1.5 Compliances to Legal Requirements

Complying with the Law of Land is everyone's duty towards the state. It is also important because most of the non-compliance comes with a penalty attached with it that results in loss of organizational resources.

Some of the Acts that may be applicable to an NGO are:

- Society Registration Act
- Trust laws
- Section 25 of Companies Act
- FC(R)A
- Income Tax Act
- Provident Fund
- Payment of Gratuity Act

Financial Information provides maximum information for the compliance of most of the above Laws. The information for filing of return like that of FC(R)A department (filing of FC3) comes from the financial system. Information about the PF and Gratuity comes from the payroll system, a part of the financial system. Thus the compliance of law of the land too depends much on the financial system of the organisation.

## 1.6 Reporting

Reporting is generally of two types: Internal reporting & External reporting. Some of the internal reports prepared by an organisation on regular basis are:

- **Trial Balance:** Monthly trial balance is the summary of balances of all the ledger accounts. Due to the use of a double accounting system, the total of debit balance and that of credit balance should match. This is a check to ensure that all the accounting has been done correctly.

- **Variance Analysis:** Budget Vs Actual, i.e. the variance analysis finds the deviation of actual income and expenditure from the budgeted one so that corrective action can be taken and the implementation is kept on track.

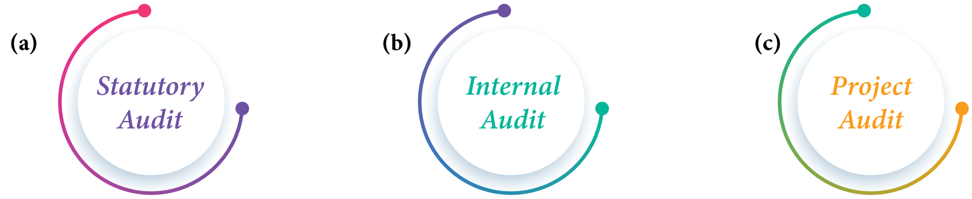
• **Internal Audit Report:** Internal Audit is done to ensure that all the work and its accounting is done properly. Assets and resources of the organization are secured and policies of the organisation are being followed properly. The Internal Auditor presents its report to the management who takes action on the observations requiring its attention and action. Action taken report is prepared by the management which is then presented to the governing board along with the internal Audit Report.

The external Reporting is done for the external stakeholders. The most important external reporting is the Annual Statement of Accounts. The Annual statement of Accounts is audited by the external Auditors to present his opinion on the state of affairs of the organisation. Another major reporting is that of FC3 required under FC(R)A which is the statement of receipt and utilization of foreign source funds. For the external grants, the organisation has to report to the donor in the forms prescribed, if any. It majorly consists of reporting of utilization of grants on a periodic basis.

Organisation deducts Tax at source from some specified payment made to various vendors of goods and services. The Tax thus deducted is then deposited to the government account with banks. A return is filed with the Income Tax authority to report the Tax thus deducted and deposited. There are legal provisions that regulate it.

## 1.7 Audit

Audit is the process of examination of books of accounts and the financial statement by an independent person so as to give his opinion on the state of affairs of the organisation. In NGO context there are 3 types of audit involved, they are;




**Types of Audit**

- **Statutory Audit:** It is an audit required to be done as per the provision of laws of land. The Audit in India is generally done by the Qualified Practicing Chartered Accountants. This is done in line with the legal requirement, the report of which is submitted to the government authority as well as to the general public.

- **Internal Audit** as already discussed is done for reporting to the management about the conduct of work in line with the policies of the organisation. Organisation generally appoints full time Internal Auditors who may or may not be a Qualified Chartered Accountant.

- **Project Audit** is specific to a project. The opinion given by the Auditor is for the state of affairs of the project. Auditors generally attest the Income & Expense or Receipt & Payment Account known as utilization statement. The statement of utilization is generally prepared in the format prescribed by the donor funding the project that mandates the project Audit. The frequency of the Audit is also defined by the Donor. Project Audit too is done by Qualified Practicing Chartered Accountants.

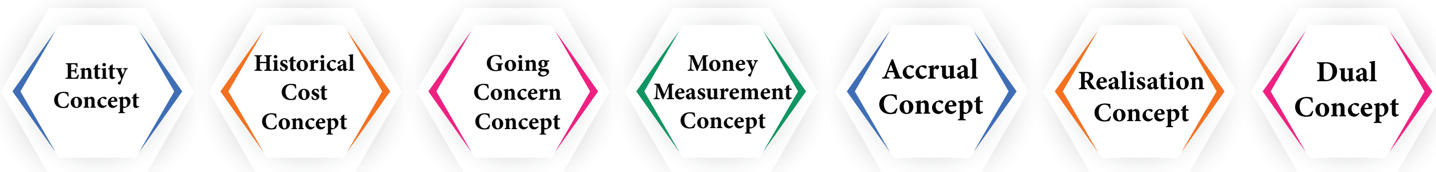
# Chapter 2

## Accounting Concepts & Conventions

In order to maintain books of accounts one has to understand prevailing accounting policies, principles & concepts.

### 2.1 Accounting Concepts

The following are the basic concepts which are necessary to understand and practise accounting:




- **Entity Concept:**The NPO is considered separate from the persons who operate it. In other words, it is treated as an artificial legal person. It means that an entity has a separate existence apart from those who hold it, manage it or benefitted by it. Therefore, one can understand that any receipt from any person is treated as a liability or income. Similarly, any payment is either asset or expenditure. Without this concept, the records of multiple entities would be intermingled, making it quite difficult to determine the financial or taxable results of an NPO. This concept helps to give a correct determination of the true financial position of the organisation.

- **Historical Cost Concept:** A historical cost is a measure of value used in accounting in which the value of an asset on the balance sheet is recorded at its original price when acquired by the organisation. All transactions are recorded at the cost price and any fluctuation in the market value are normally not accounted for.

The advantage of the historical cost principle is that the users of financial statements could know exactly the original value of Assets or Liabilities in the financial statements as it requires no adjustments. However, the other side or disadvantage is that the value of an asset which would have changed, i.e. appreciated or depreciated would not be factored in, thereby impacting the

• **Going Concern Concept:** In this concept of accounting, it is assumed that the organisation has a perpetual existence. Accordingly, transactions are recorded on long term basis. It implies that the NPO will continue its operations in the future and will not discontinue operations due to any reason. An organisation is a going concern if no evidence is available to believe that it will or will have to terminate its operations in foreseeable future. This results in accounting of assets and liabilities. If going concern in not considered as a concept, then all assets and liabilities would be charged off at the time of incurring them. It would again not provide a true and fair view.

• **Money Measurement Concept:** Only those transactions which can be measured in money are recorded. It is an important accounting concept that is based on the theory that an organisation should be recording only those transactions that can be measured or expressed in monetary terms on the financial statement.

Money measurement concept is also important from the point of view of 'accounting conservatism'. In other words, if this concept is not exercised there will be wild assumptions and presumptions which will not be realistic, thereby compromising on the credibility of the financial statement.

As the financial transactions are recorded which have monetary value therefore, it becomes easy when two separate accounting periods are compared. It also provides a clear picture of the financial transactions and state of the organisation.

• **Accrual Concept:** It is based on the concept that transactions are recorded as and when they occur. In other words, NPOs that follow the accrual basis of accounting need to record income and expenses when a transaction occurs regardless of when payment for the same is received or made. According to this concept, expenditures or liabilities even if not incurred are taken into account. Similarly, accrued incomes even if not received are also taken into account. So the accrual concept always takes into account the expenses and income on due basis rather than payment/receipt basis.

• **Realisation Concept:** IRealization concept is part of the broadly revenue recognition principle which underlines the importance of income or revenue to be recognized only when it is earned. The entity should be reasonably sure that the receipt/income will be received from the party. It generally applies in a situation where risk and rewards are transferred, or income gets due, irrespective of the fact whether the amount is received or not.

Realization principle deals with the recognition of revenue. In case of a continuing relationship, revenue to be recognized on percentage completion method. According to this concept, revenue is to be recognized only when it is earned, or it becomes reasonably certain that the company will receive the payment from its customer where this revenue is realized when risk and rewards are transferred, or income is due. Realization principle does not account for receipt of cash, i.e., income is to be realized, or revenue is to be recognized even if the cash is not received. For example, if the advance is received, but goods are not transferred, revenue cannot be recognized. It is to be recognized only when goods are delivered.

• **Dual Aspects:** As per this accounting concept, it is known that any transaction of a business is recorded in two separate accounts. The dual aspect concept indicates that each transaction made by an organisation have two different aspects which are equal and opposite in nature. This concept explains that if something is given, someone will receive it. This can be explained as whenever a transaction occurs, there is a two-sided effect, one is credit, and the other is debit for a similar amount. In simple term it is called 'double entry'.

## 2.2 Accounting Conventions

Accounting conventions are guidelines used to help NPOs determine how to record transactions. It is used when there is not definitive guidance in the accounting standards that govern a specific situation. Thus, accounting conventions serve to fill in the gaps not yet addressed by accounting standards.:

• **Consistency:** IAll transactions are treated in a similar pattern from year to year. For instance, if we are valuing materials at cost in one year, we should not value the same at market value in another year. This convention promotes comparability and analysis.

• **Disclosure:** All financial statements should disclose all the significant accounting policies followed.

• **Conservatism:** All financial statements should be drawn on the principle of conservatism. The convention of the conservatism of accounting advises to provide for all the losses and liabilities and understate the profits and assets. **Though now-a-days prudence is considered to be a more appropriate convention rather than conservatism.**

## 2.3 Capital & Revenue Concepts

This is one of the most important thing to understand in accountancy i.e. Capital and Revenue receipts & expenditure.

**Capital expenditure** is the one whose benefit is not extinguished within a short span of time. For example, expenditure on construction of a Building, the benefit of such expenditure will be available to the NPO for years together. On the other hand, Revenue expenditure is an expenditure whose benefits are either exhausted immediately or within a short span of time. Another example would be, expenses on travel or repair on vehicles, the benefit from such expenditures normally are for a short period not exceeding one year, therefore they are to be written off as revenue expenses.

Similarly, **capital receipts** are those receipts which are specifically received to be spent on capital expenditures. For example, corpus donation, grant for building etc. On the other hand, any amount received in the day to day routine of the organisation including donations, membership fees, interest on bank accounts etc. are **revenue receipts.**

Since, both capital receipts & capital expenditures are of enduring nature, both of them find a place in the Balance Sheet. Buildings, Furniture, Plant & Machinery etc. are examples of capital expenditures. Capital fund, Corpus fund, assets fund etc. are examples of Capital receipts.

## 2.4 Methods of Accounting

**2.4.1 Cash Basis of Accounting:** Cash basis of accounting is referred to as that method of accounting where the accounting system recognizes revenues and expenses only when there is inflow and outflow of cash. An entry in the books of account is made only when cash is received or paid except for closing, opening & few adjustment entries.

For example, goods and services purchased/availed are recorded as assets or expenses at the time they are paid while revenues, including grants and donations, are recorded at the time of actual receipt or transfer of funds. Amounts payable, liabilities outstanding or amount receivable are ignored and not accounted for in the books.

The cash basis of accounting is widely preferred by the voluntary organisations over accrual basis for reasons of simplicity in its application. Even non accountants, who have a good grasp of the principle of debit and credit, can fairly perform the job. Many voluntary organisations also view that accrual basis of accounting is useful for profit-making organisations and income generating projects.

Further, most of the funding agencies and provisions of Foreign Contribution (Regulations) Act, 1976 primarily require the actual receipt and disbursement utilisation/application of funds/grants/income, thereby approving the cash basis of accounting.

### Advantages of Cash Basis of Accounting:

- Cash only transactions are simpler to maintain.
- The requirement of skills for managing cash transactions is less as compared to the more complex accrual basis of accounting.
- It provides a clear view of the amount of cash possessed by the NPOs

### Disadvantages of Cash Basis of Accounting:

- It provides a less accurate picture of the financial position of the business as compared to the accrual basis of accounting.
- The data can be manipulated by deferring payments or late deposit of cheques

**2.4.2 Accrual Basis of Accounting:** Accrual basis of accounting, is also known as the Mercantile Basis of Accounting. It is slightly more complex process of recording of transactions. It is based on the concept that transactions are recorded as and when they occur. In other words, NPOs that follow the accrual basis of accounting need to record revenues and expenses when a transaction occurs regardless of when payment for the same is received or made.

Revenues including grants are recorded at the time when they are earned or become due irrespective of the fact as to whether the amount has actually been received or not.

### Advantages of Accrual Basis of Accounting:

- It helps the NPOs in providing a more realistic representation to the stakeholders.
- It allows for easy planning as the NPO accounts for all the income and expenses that will occur during the accounting period and prepare a budget accordingly.

### Disadvantages of Accrual Basis of Accounting:

- It can be complicated requiring more skill, time and resources.
- It can give an unfair view of the short term financial position of the company

**Illustration:** To understand the difference between Cash and Accrual system of accounting, let us take an illustration:

- Nimhas received 50,000/-,
- Purchased the Brochure & Banner - 30,000/-
- Paid only 20,000/- to the supplier & 10,000/- was agreed to be paid later
- While travelling the actual expenditure was 4,000/- but he paid 5,000/- an additional amount 1,000/- was paid as advance

Based on the above information, let's draw a Trial Balance as per the Cash Basis Accounting & Accrual basis of accounting.

### Entries to be passed on Cash Basis Accounting Method

| Date | Particulars | Ledger Folio no. | Debit Amount | Credit Amount |
|---|---|---|---|---|
| | Brochure & Banner Account Dr. | | 20,000.00 | |
| | To Cash Account | | | 20,000.00 |
| | (Being Brochure & Banner of ₹30,000/- purchased out of which ₹20,000/- is paid & ₹10,000/- remains outstanding) | | | |
| | Travelling Account Dr. | | 5,000.00 | |
| | To Cash Account | | | 5,000.00 |
| | (Being ₹5,000/- incurred for travelling including 1,000/- as advance for next year) | | | |

### Trial Balance as per Cash Basis Accounting Method

| Particulars | Debit | Credit |
|---|---|---|
| Cash Account | 25,000.00 | |
| Brochure & Banner Account | 20,000.00 | |
| Travelling Account | 5,000.00 | |
| Grant Account | | 50,000.00 |
| Total | 50,000.00 | 50,000.00 |

(Assuming a Cash Donation Receipt 50,000/-)

### Entries to be passed on Accrual Basis Accounting

| Date | Particulars | Ledger Folio no. | Debit Amount | Credit Amount |
|---|---|---|---|---|
| | Brochure & Banner Account Dr. | | 30,000.00 | |
| | To Cash Account | | | 20,000.00 |
| | To Outstanding Expense Account | | | 10,000.00 |
| | (Being Brochure & Banner of ₹30,000/- purchased out of which ₹20,000/- is paid & ₹10,000/- remains outstanding) | | | |

| Date | Particulars | Ledger Folio no. | Debit Amount | Credit Amount |
|---|---|---|---|---|
| | Travelling Account Dr.<br>Prepaid Expense Account Dr.<br>To Cash account<br>(Being 5,000/- incurred for travelling including 1,000/- as advance payment to be adjusted for next year) | | 4,000.00<br>1,000.00 | <br><br>5,000.00 |

**Trial Balance as per Cash Basis Accounting Method**

| Particulars | Debit | Credit |
|---|---|---|
| Cash Account | 25,000.00 | |
| Brochure & Banner Account | 30,000.00 | |
| Outstanding Expense Account | | 10,000.00 |
| Travelling Account | 4,000.00 | |
| Prepaid Expenses Account | 1,000.00 | |
| Grant Account | | 50,000.00 |
| Total | 60,000.00 | 60,000.00 |

(Assuming a Cash Grant Receipt 50,000/-)

When we compare these two Methods of Accounting with the help of the Two Trial Balance prepared by Nimhas we find that under Accrual Method there are two additional accounts, Outstanding Expenses Account and Prepaid Expenses Account.

## 2.5 Suggested Accounting Policies

The available international accounting standards and other country specific accounting standards are not designed specifically for NPOs. Therefore, there is a necessity to initiate a process for designing a guiding tool for adopting accounting policies for NPOs.

In India the Institute of Chartered Accountants of India (ICAI) has issued a Technical Guide which recommends use of their Accounting Standards wherever applicable.

### 2.5.1 Background to NPO Accounting

The selection and application of accounting policies for NPOs should be based on the appropriateness of such policies keeping in view the inherent peculiar characteristics of NPOs. NPOs do not work on the principles of ownership & for profit unlike commercial organizations. Their project oriented activities are for a specific time frame; therefore, the going concern assumptions do not apply to all the activities of the NPOs.

In case of externally funded projects, debiting outstanding expenses at the close of the project under accrual basis may again result in unresolved financial statements.

When an NPO is handling different project/restricted funds then for accounting purposes there are different fiscal entities existing simultaneously which the conventional accounting standards do not account for as it is not relevant in the commercial arena.
In such circumstances it is imperative that NPOs develop accounting policies which are sensitive enough to address various NPO specific practices which are not found in commercial organizations.

The International accounting standards also provide the discretionary leverage to all organizations to ensure that the accounting policies are appropriate and relevant to their work and activities. IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, specifically provides that the management should use its judgement in developing and applying an accounting policy.

The accounting standards issued by various authorities are mandatory only on the members of such institutes. For instance, a mandatory accounting standard in India is not a legal obligation on the part of a registered society or a trust. However, accounting standards provide a uniform guiding principle for accounting practices and reporting.

### 2.5.2 Disclosures of Accounting Policies

Fundamental Assumptions: The fundamental accounting assumptions shall be (a) going concern, (b) consistency, (c) accrual basis. The aforesaid fundamental assumptions will be applicable to the NPO as a whole. However, NPOs should follow the principles of fund accounting and as a result they should recognise various independent fiscal entities for accounting purposes. The fundamental accounting assumptions may not apply to all the fiscal sub entities.

The assumption of going concern may not apply to time bound projects initiated out of restricted funds.

The assumption of accrual basis shall not apply (for reporting purposes) to project implemented through external funding where the donor insists on cash basis of accounting and reporting. Because such projects are bound by contractual obligations which may not permit outstanding expenses or recognition of income in lieu of commitment. Further use of accrual basis may not provide conclusive statements to the satisfaction of the donors at the time of preparing the statements at the end of the period. However, the auditor should adequately clarify the various policies followed by the organisation particularly if there are some deviations from the accounting standards issued by ICAI.

It should also be noted that even if an NPO is following accrual basis of accounting it can always prepare certain special purpose statements on cash basis as in the case of FCRA statements or as per donor's requirements

### 2.5.3 Accounting Policies

Accounting policies are procedures that an NPO uses to prepare financial statements.
Accounting policies can be thought of as a framework in which a NPO is expected to operate.

However, the framework is somewhat flexible, and the NPO's management team can choose specific accounting policies that are advantageous to the financial reporting of the organisation.

- **Fund Accounting**

The principles of fund accounting recommend that various funds and activities which are not necessarily in the discretionary domain of NPOs should be treated as separate accounting entities and the contractual obligation attached to each such fund or activity should be independently and exclusively addressed to. All NPOs should follow the principle of fund accounting. For details on fund accounting Module 4 on Fund Accounting may be referred.

Fund accounting does not require any specialised accounting norms or policies. The normal accounting policies should be applied but as per the specific requirement of each fund or activity.

In fund accounting each project or fund is treated as a separate entity and all the information pertaining to that particular fund is provided separately including investments, assets, balances, etc.

- **Depreciation**

Depreciation can be defined as a continuing, permanent and gradual decrease in the book value of fixed assets.

- **Valuation of Stock and Inventories**

NPOs which are not engaged in any trading and manufacturing activities may also carry some goods or inventory as a part of its programme activities. In such cases if the NPOs procure, assemble or prepare goods and materials for distribution purposes, then such inventories should be treated at cost. If the replacement cost of such material is lower than the actual cost, then the valuation should be made at the replacement cost.

The ICAI further recommends that NPOs receiving goods and materials either free of cost or at nominal cost should make suitable disclosure regarding the market price or estimated realisable value of the materials lying at the year end.
Quantification of goods and materials received free of cost also becomes important for reporting under FCRA, where separate details are required to be given in this regard.

- **Treatment of Grant and Revenue Recognition**

A project grant shall be treated as income only if there are no restrictions placed in the project contract by the donor. Therefore, restricted grants shall not be treated as income in the books of the NPOs. The restricted grants shall be recognised as a legal obligation as and when realised on the principles of fund accounting. Receipts and applications of restricted grants shall be made in the respective fund account. In other word all restricted grants received shall be accounted for on realisation/receipt basis only.

All voluntary contributions and donations received shall be treated as income as per AS-12 on the basis of duly approved grant letters, specifying time frame/guidelines of grant accrual.

All other incomes such as membership fees, interest, royalties, dividend, income from income generation activities and income from fundraising activities shall be treated as income as per AS-9.

- **Capital Expenditure & Fixed Assets**

Keeping in view the trusteeship function of NPOs, the assets procured out of restricted funds need to be distinguished. Similarly, there will be no distinction between capital and revenue expenditure as far as it relates to application of funds for projects and programmes initiated towards achievement of the objectives.

However, the normal accounting conventions pertaining to capital and revenue items shall be adhered to as far as it relates to other transactions of the NPO. The variable treatment of capital and revenue items shall necessitate the distinction between project assets and capital assets.

The assets shown as application of funds under various projects shall be treated as project assets. If the source of fund against such assets is treated as income, then such assets should be shown at nominal value in the books of accounts. The NPOs may also create an asset fund to show the assets at their original value. But if the source of funds against project assets is not treated as income, then such assets should form a part of that particular fund account like any other asset.

# Chapter 3

## Specific Financial Practices for Non-Profit

While the broad principles of accounting would apply irrespective of any circumstance, its application would have to be adapted as per the needs of the situation. This is true when we are discussing the issue of for-profit accounting vs. non-profit accounting. Many times the accounting principles relevant for a for-profit organisation are applied in a non-profit situation. This leads to a lot of confusion and miscommunication. Hereby we are going to discuss few of the contentious and complex issues from a non-profit accounting perspective.

### 3.1 Profit V/S Surplus & Loss V/S Deficit

Generally, in commercial accounting, determination of profit and loss is an important indicator of the financial health of the organisation. A profit at end of the financial year would indicate success of operations while loss would indicate the shortcomings and failures. Therefore, the determination of these two parameters (profit or loss) are considered an important exercise.

However, if we consider a non-profit organisation, since it exists for social purposes, profit or loss is not a determining factor for loss or success. Unfortunately, in the general parlance the financial statement of a non-profit is borrowed from the for-profit framework. This has resulted in mirroring the for-profit financial statements. Therefore, the word 'profit' has been replaced by 'surplus' and 'loss' by 'deficit'. Unfortunately, surplus or deficit does not communicate the same conclusions as that of profit or loss. In fact, they mean nothing. For example, how would you interpret a financial statement of an organisation which has closed with a surplus. One interpretation would be they have been efficient in the cost control, but the second interpretation would be that they have bene inefficient in implementing the programmes. Similar would be the case for loss and deficit. Therefore, a different parameter is needed for accounting and reporting of non-profit organisation.

## 3.2 Budget and Actuals

For a non-profit organisation, budget is a very important tool for planning. A well-planned budget will focus on the primary goals and objectives of the organization; it further helps in attaining the maximum desired result without derailing from the actual plan. Thus, the cash flow plan, planned activities, project objectives and the overall plan of the organisation can be achieved in a year, simply by having a thorough budget planning exercise. However, it does not mean that there cannot be deviations in the plan and the actual result. Sometimes, there can be minor deviations due to some unknown/unavoidable factors which can be considered while the substantial deviation reflects that the financial management function of an organization is not well-structured.

Budgetary control is another important tool in the process of budgeting exercise. It involves continuous comparison of actual results with the planned ones and taking corrective actions in the organisation. Thus, it can act as a road map for another year's budget planning exercise.

## 3.3 Cash Flow

Cash flow is the money that is moving (flowing) in and out of your organisation or project over a period of time. Although it may seem that cash only flows out, in reality unless there is inflow, there cannot be outflow. So it flows both ways and thereby keeps organisations afloat!!!
You may have a very good project and a donor, but if the periodic cash inflow matching with the out flow is not worked out, then the organisation will get into a situation where it may have the committed grants on paper but may find it difficult to clear off liabilities in the short run. Therefore, cash flow is a very important planning tool

## Cash vs. Real Cash

For some business organisations, like restaurants and some retailers, cash is really cash: currency

The business takes cash from customers and sometimes pays its bills in cash. Cash based Organisations have a special issue with keeping track of cash flow, especially since they may not track income unless there are invoices or other paperwork.

Picture cash flow in this way. If more money is coming in than is going out, you are in a "positive cash flow" situation and you have enough to pay your bills. If more cash is going out than is coming in, you are in danger of running dry, and you will need to find money to cover your costs

## Why Cash Flow Is So Important?

Lack of liquidity is one of the biggest reasons organisations get into trouble sometimes. It's also called "running out of money," and it will drastically affect program implementation as well as staffing.

Starting a new project: Dealing with cash flow issues is most important when you are starting a new project. You have to project your expenses and outflows very clearly. You will need to match your cash inflows and outflows in order to match them.

## 3.4 Accounting of Own Means Contribution (OMC)

Own Means generally refers to the component of resources and funds mobilised or contributed by the implementing or co-ordinating partner of a development project. In an externally funded project own means could be the value of goods & services and funds other than the grants received from the donor agency.

In other words, own means is the commitment or contribution of various stakeholders to the project other than the funding agencies. A donor/funding agency normally does not finance 100% of the project and it expects that the following stakeholders should contribute the remaining amount of funds or resources:

- Partner organisation
- Community based organisation
- Beneficiaries
- Other local organisation
- Government Agencies
- And, at times, co-funding organisations

| Importance of OMC | | | |
|---|---|---|---|
| Target Community partipation in development process | Creates Greater Ownership and Contribution to programme | Project Sustainability | Strengthening Responsibility |

The OMC in cash and in-kind can be raised through various sources. There are few of the sources listed in the table given below:

**Importance of OMC**

| CASH CONTRIBUTION | NON-CASH CONTRIBUTION |
|---|---|
| Organizational Funds | Resource Persons fees, Conveyance Charges not charged |
| Cash contributions from Community members | Kind Contribution from the community, target groups, etc. |
| Grants received from other Local or Foreign Donor agencies towards the project | Resources mobilized during the trainings, workshops etc. |
| Cash contributions from Community members | Providing facilities at Resource Centers (Voluntary labor, provision of meeting/training spaces, food, etc.) |
| Cash Income from fees for attending workshop, trainings etc. | |

### Accounting Policies and Consultation with The Auditor

Each organisation should develop a guideline for assessment, documentation & accounting for own means, keeping in view the requirements of the funding partners. Certain components of own means may not find place in the books of accounts of the partner organisation, in such circumstances subsidiary statements and records may be prepared. Lot of organisation face difficulty in convincing their Auditor at the time of certification of such contribution, therefore it is important to involve and take advises of the Auditor from the planning stages itself.

## Suggested Practices in Assessment of Own Means of Contribution

- It should be ensured that the contribution is directly relevant to the project.
- The basis of valuation should be reasonable and acceptable.
- A written acknowledgment from the donor should always be obtained and kept as a supporting document for the own means of contribution.
- Proper subsidiary records should be prepared for all the own means of contribution generated.
- The donor agencies should be informed of the various components of own means as well as the methods of assessing the own means of contribution.
- Organisation usually face problems in convincing Auditor while certification of own means received in kind for reporting purpose. It is important that the Auditor is involved during the planning and implementation stage also.

# Chapter 4

## Probable Solutions

While the broad principles of accounting would apply irrespective of any circumstance, its application would have to be adapted as per the needs of the situation. This is true when we are discussing the issue of for-profit accounting vs. non-profit accounting. Many times the accounting principles relevant for a for-profit organisation are applied in a non-profit situation. This leads to a lot of confusion and miscommunication. Hereby we are going to discuss few of the contentious and complex issues from a non-profit accounting perspective.

### 4.1 Fund based Accounting and reporting

Fund accounting is a system of accounting which is peculiar to NPOs or not-for-profit organisations. Separate records are kept for funds created for certain specified purposes, which may be restricted or unrestricted in nature.

A fund can be defined as "a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions or limitations."

In other words, separate funds based on regulations, restrictions and limitations are required to be set up. The restrictions or designations may be placed by the donors or the management. Each fund must be treated as a separate entity and should have its own individual receipt and payment account, income and expenditure account and balance sheet. The individual funds should be consolidated and reflected in the overall statements of the entire organisation.

Fund Accounting is generally based on the activities and objectives as specified by the donors or or outside agencies. Expenditures and resources are segregated in accordance with the source and the conditions attached thereof. However, the trustee/board of the NPOs may also create and designate various funds and also lay down appropriate conditions and norms for each fund

## Characteristics & Advantages of fund accounting

Maintenance of financial records on the principles of fund accounting helps in meticulous analysis of each independent activity separately. For instance, if an NPO is engaged in several projects simultaneously, fund accounting will provide precise information with regard to each and every project at any point of time. Some instances of such information could be:

• Available Cash And Bank Balance Under That Particular Project
• Investment Held Under That Particular Project
• Any Surplus Or Deficit In The Project
•,Loan Given Or Taken From Other Project
• Administrative Component Of That Project, Etc

The availability of financial information's in a project-wise or fund- wise form enhances the financial transparency as well as decision-making. Some distinct advantages could be enumerated as under

• Measurement of project-wise and fund-wise performance
•Measurement of project-wise and fund-wise cost of activities and services
•Project-wise and fund-wise management of funds
•Project-wise and fund-wise management of assets
•Analysis of the impact of financial decisions
•Identification of project-wise and fund-wise manpower and cost allocation
•Inter-project fund transfers and recoveries thereof

From the above analysis, it is clear that fund accounting can help in providing various kind of fund/project based information, which not only caters to the reporting requirements but also help in the decision making processes of the NPO.

### Purpose of Financial Statement Is Different for NPOs

The conventional accounting statements may not provide any meaningful insight therefore, it becomes necessary to maintain sub-system and specific details to generate the desired information's. Fund accounting is one such tool which helps in providing answers to many NPO specific queries.

For instance, NPOs create endowments and corpus which may be from internal or external sources. If an endowment fund is created, then it implies that certain amount of funds is blocked permanently or on long term basis for certain specific purpose of activities. Now, it becomes important that the NPO as well as the external stakeholders know about the management and methodology involved in such fund. Therefore, the NPO has to maintain separate details for investment, assets, cash and bank balances on account of this particular fund. Similarly, the NPO also has to separately maintain the detail of expenditures made on account of this fund. Fund accounting becomes necessary for maintaining specific fund or activity-wise detail.

## 4.2 Types of Funds and Their Treatment

An NPO may have numerous fund accounts but for external reporting purposes similar funds are combined into fund groups. For instance, separate accounting may be done for all restricted projects but for overall reporting purposes all such individual fund account may be combined into a common fund account – restricted funds. Current funds imply that they are available for application for either restricted or unrestricted purposes. All funds other than permanent or long term funds such as corpus and endowments are considered as current funds.

Current funds basically include all the active funds of an NPO. The fund which are available for application for any purpose with or without restriction are current funds. Another way of looking at current funds could be the funds which find a place in the income and expenditure account of the organisation. For example, a corpus fund is a permanent fund and any receipt towards corpus is directly taken to the balance sheet without being shown as income in the income and expenditure account. The following are few of the commonly used fund groups under current funds.

## Current or General Funds

Current or General Funds, hereinafter referred to as 'CF', are those funds, which reflect the financial resources/surpluses available for general operations. Such funds are generally created from

- The excess of income over expenditure of a charity in a normal course of functioning
- Income generation activities
- Interest earned from various unrestricted fund
- Rent received
- Membership fees
- Miscellaneous sources, etc

In each financial year, an NPO may have certain unrestricted funds available from the above mentioned sources. Such funds can be utilized in carrying out the primary objectives of the organization

## Current Unrestricted Funds

Current unrestricted funds, hereinafter referred to as 'CUF', reflect the grant and resources received without any conditions or stipulation by the donor agencies. In other words, all voluntary contributions where the donor does not specify any condition regarding the use of fund can be treated as CUF.

The distinction between a CF and CUF is the internality and externality of their generation. All CUF are generated through external sources and all CF are generated by the organization through its own sources. However, in both the cases there is no restriction on the use of such funds for any specific purposes. Therefore, if an NPO is in a position to calculate both the CF and CUF, anytime during the year then it can plan its own unrestricted activities for which no fund from any donor is available.

## Current Unrestricted Specified Funds

There could be some unrestricted voluntary contribution received for a broader spectrum of activity. For instance, an NPO collecting funds for the girl child through donation boxes, such receipts are voluntary in nature but at the same time the larger intent of the donor is specified. Therefore, even if there is no restriction for any particular type of activity but the funds have to be spent for the benefit or development of the girl child. Choosing the type of activity may be at the discretion of the NPO but the segment of activity is defined at the time of receipt. In such cases, the restriction is on the specific objective rather than a particular activity as in the case of a restricted fund supported with a project proposal and budget.

## Current Designated Funds

Current designated funds, hereinafter referred to as CDF, is created out of unrestricted funds by the management of the NPO or the trust. The board of an NPO may designate the unrestricted current fund for any specific purpose or activity. The designation may be for programme or administrative purposes. The board of the NPO may change the designation at any time and re-designate the same for other purpose. For instance, the CDF may be created for some of the following purposes:

- Any specific activity designated by the Board of Directors
- Emergency medical expenses for staff members with approval of the board

• Staff capacitation measures which are not funded under any restricted projects

• Participation in seminars, conferences, international meets

• Expenses on fund raising initiatives, etc.

The designated funds can provide a deep insight into the programmes and values of the organisation because it is something at the disposal and discretion of the organisation. In case of a restricted fund the organisation does not even have the opportunity of becoming judicious in identifying the modes and purposes of application. However, in case of designated funds, the organisation can internally decide the purpose, mode and methodology for retention or use of funds. The various kinds of designated funds created can provide a clear idea about the approach of the NPO, the important activities and the sustainability perspectives.

## Current Restricted Fund

Current restricted fund, hereinafter referred to as CRF, are the funds available with the organisation with conditions and stipulation imposed by the donors. All project grant based on project agreements are restricted funds. They are CFs available for application in the short or medium terms. But the NPO does not have any discretionary power for determining the mode and purpose of utilisation. Such funds have to be used as per the approved budgets and activities. Even the expenditures heads are pre- determined for such funds.

The stewardship/trusteeship aspect of the NPO is very apparent in the framework of restricted fund. Such funds are treated as the belonging of the donor and NPO is merely a catalytic conduit for application of such funds. The NPO keeps and utilises fund on behalf of the donors. Therefore, it has the dual responsibility of effectively utilising as well as safeguarding such funds. At the end of each project, if there is any surplus then such surplus may either be refunded or may be transferred to the CUF with prior approval from the donors. Any asset, surplus or deficit at the end of the project belongs to the donor and it has to be retained or refunded as per the terms of the agreement or any other direction received from the donor.

A restricted fund may have an interface with unrestricted funds also. For instance, in some projects the donor does not fund 100% of the budgeted amount. A specified percentage of the project cost is provided by the NPO as own means of contribution. If such own means of contribution comes from internal unrestricted sources, then the expenditures for the project will come from two sources one from the restricted fund belonging to the donor and the other from the unrestricted fund from which own means of contribution was made. Then an accounting entry for transferring the own means from unrestricted funds account to restricted funds has to be passed which would not have been required in conventional accounting system.

## 4.3 Allocation of Common Costs

Cost allocation approach is the process of allocating the common cost of various cost centers to various projects being carried out by an organization in an equitable way.


The most important aspect in the process of applying this approach is to understand the concept of common cost and the fair basis on which it can be charged to various cost centers.

### What is Cost Centre??

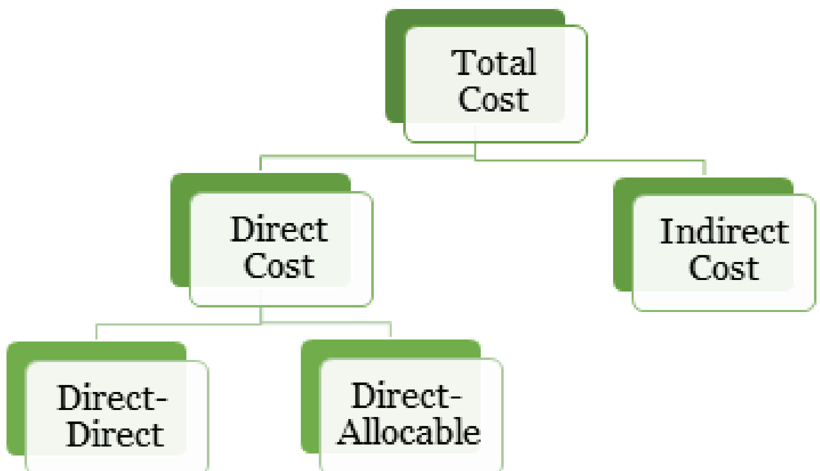
- It is a unit or department of the work place where cost is incurred.
- It may be the Programme department, Finance Department, Project support Department, Administration Department or any other units as can be perceived and set up in an organization.
- These centers have the running cost.

• The cost may either be particularly for a specific project or donor or may be for more than one project/donor. Even when the cost of the Centre is not specifically for a project/donor, it can fairly be apportioned and charged to different donors/projects.

**If cost can be fairly apportioned, then what could be the problem??**

The problem arises when **the basis of allocation cannot be clearly determined** while charging a common cost to a donor/project. Even though cost allocation cannot ensure cent percent accuracy, it would certainly mitigate the arbitrary approach of charging expenses to the donors/projects to a large extent.

## Cost allocation Approach:




**Direct Costs-** The Costs which can easily be identified with a project and donor.

**Indirect Costs-** The Costs which cannot be identified with any project(s)

*Always ask yourself, "Will this cost be incurred if no project would be running for the time being".*

**Direct-Direct Costs** are those which can be directly identified with one project.

*For example: Cost of conducting campaign on HIV Aids*

**Direct-Allocable Costs** are those which can be directly identified with more than one project.

*For example: Salary of Project Coordinator, who is in-charge of more than one project*

We now need to identify the basis on which cost can be allocated. Basis of allocation is the relationship between the expenditure and the project.

For example: The salary of the finance person can be easily related to the expenditure for the project. Similarly, rent can be allocated on the basis of the floor area used by the program department for each project.

However, it is not always easy to find the basis and at times more than one basis can be identified. Better understanding of the operation of organization and nature of expenses helps in arriving at the basis of allocation. Use of wrong basis would vitiate the very purpose of cost allocation and result in inappropriate charging of the expenses to the project and in turn the donor.

## Implementation of the cost allocation approach:

The cost allocation policy must be formulated and implemented by the Executive Director of the organization in consultation with the project staff, finance team and the auditor. Once the Cost Allocation Policy is ready the same must be shared with the Board and the donors.

## Benefits of cost allocation approach:

Expenses should be charged to donors fairly which can be justified. Cost allocation brings transparency to the charging of expense to donors as well as to other sources. Besides, following benefits comes attached with it;

- The budget is made on the basis of the recovery rate thus calculated with precision of better confidence level.
- In case some costs are not supported by any donor, **we will have understanding of the amount that we may have to generate on our own**.
- We will have **valid basis** on insisting donor to support the cost as derived using the cost alloca-

• Since the allocation is based on realistic approach, it would be helpful in preparing budget for the project.

• We will not have to adjust the charging instructions every now and then. We will not have to do so many reversals and recharging to donors.

• The reporting to the donor would be consistent.

## Conclusion:

The cost allocation becomes relevant as soon as the Voluntary Organization starts receiving fund from multiple donors. The cost allocation approach is a new advent and needs continuous emphasis in order to be properly implemented in the Voluntary Organization.