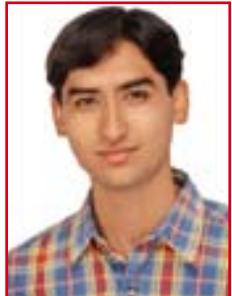


NGOs—ACCOUNTING AND LEGAL INTRICACIES



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In the absence of any legal authoritative pronouncement and varied interpretation of certain terms under the related laws by the judiciary, it has become a difficult task to follow a uniform line of action in preparation and presentation of the financial statement of an NGO. The practices followed by an NGO on certain issues are varied and diverse thereby making the financial statements incomparable and difficult for users to understand. The intricacies range from the accounting treatment of certain items of income/expenditure, to the issues under legal laws in force at present.

is a need for consensus on certain varied accounting as well as legal issues so that a more meaningful financial reporting and disclosure can be made. This would not only make the financial statements of these organisations comparable, but would also provide the user of these statements a bird's eye view of the activities of such organisations. The succeeding paragraphs deal with some such intricacies, which need consensus.

Accounting of Grants

NGOs receive grants from government as well as other national and international agencies. *Para 13 of the Accounting Standards (AS) 12 - Accounting for Government Grants provides that Government Grants should not be recognised until there is reasonable assurance that (i) the enterprise will comply with the conditions attached to them, and (ii) the grants will be received.* Even if Accounting Standards are not applicable to an NGO, the principles of accounting laid down in AS-12 should be followed. Grants may be of the nature of project based grants, or comprehensive grants not related to a particular project but for the general purposes of the 'grantee' organisation. At present three practices are widely followed in recognition of grants:

Nowadays, Non-Governmental Organisations play a vital role in bringing the under-privileged and least-advantaged to the common stream of the society. With the passage of time, there has been a big increase in their physical as well as financial activities. Their presence has also increased from the national to the international level and the source of funds has also diversified from private donations to international funding agencies. Due to this manifold increase, there

i. Grants recognised as income: Most of the NGOs recognise a grant as income in the year in which it is received. The amount expensed out of this amount is shown as expenditure in the Income and Expenditure Account. While the total amount of grant received is shown as income in the Income and Expenditure account,

in a strict sense grants are not income as they are given not to accumulate but to spend for a particular project or the core activities of the organisation. Sometimes these grants have to be returned to the funding agency and the overspent balance can be charged from these agencies, if the agreement between the two provides so. The main advantage of recognising a grant as income is that the whole income and the expenditure incurred out of this income is shown in Income and Expenditure Account which can provide meaningful information to the user of the financial statement about the activities and spending pattern of the organisation. However, recognising a grant as income may result in showing higher surplus for the year, which is actually unspent grant. It may further lead to an impression that the surplus is available to the NGO for spending wherever it wants but that is not the case as the surplus is the unspent grant which is usually project based or earmarked. Further, adoption of this method understates liabilities as the unspent balance of grant become surplus and showed as reserve. The other disadvantage of this method is that there may be surplus in one year and deficit in another year due to effect of unspent and overspent grant that makes figures incomparable. If this method is followed the Income and Expenditure account and Balance Sheet will appear as shown on the right.

ii. Grants recognised as liability: This is another method of recognition of grants. In correct sense, the grants are money of the donor agencies, which are given to an organisation to be spent in a particular manner. This is not the income of the organisation, which is freely available for any use. That is why many NGOs recognise grants as liabilities in their balance sheet. The expenditure is deducted directly from the balance of the grant and does not form part of the Income and Expenditure account.

Income and Expenditure account	
Income	Amount (Rs. Lakhs)
Grants	20
Donations	5
Total Income (a)	25
Expenditures:	
Development Expenses	10
Other Expenses	2
Total Expenditures (b)	12
Net Surplus (a-b)	13

Balance Sheet	
Sources of funds	Amount (Rs. Lakhs)
Corpus fund	10
Surplus	13
Total	23
Application of funds	
Fixed Assets	10
Investments	12
Current Assets	1
Total	23

The unspent/overspent balance is shown as a liability or asset respectively in the Balance Sheet. If this method is followed, assets and liabilities are fairly shown in the balance sheet and the figures of Income and Expenditure accounts are comparable from year to year as grants and the expenditure incurred out of it does not form part of the Income and Expenditure account. The major disadvantage of using this method is that it results in showing that the NGO is inactive, as the development expenses do not form part of expenditure in Income and

Expenditure account. The other disadvantage is that overspent balance of a grant is shown as an asset item that may not always be recoverable from the donor agencies.

Income and Expenditure account	
Income	Amount (Rs. Lakhs)
Donations	5
Total Income (a)	5
Expenditures:	
Other Expenses	2
Total Expenditures (b)	2
Net Surplus (a-b)	3

Balance Sheet	
Sources of funds	Amount (Rs. Lakhs)
Corpus fund	10
Surplus	3
Unspent grant	10
Total	23
Application of funds	
Fixed Assets	10
Investments	12
Current Assets	1
Total	23

iii. Grants recognised as income only to the extent of the expenditure incurred: Under this method, grants are recognised as income but only to the extent of expenditure incurred out of it. The unspent or overspent balance is shown as liability or assets in the Balance Sheet and in the Income and Expenditure account the unspent balance is deducted from the grant received. This matches the amount of the grant (income) and the expenditure exactly. However, the unspent balance can

be deducted from the total grant in the Income and Expenditure account but if there is overspent balance it cannot be added to the income. The concept of prudence should always be born in mind whenever accounting for such issues is done. Preferably, it is better not to recognise such income which has not been received or has not become due to be received or until there is reasonable certainty of such receipt. This method has advantages of both the earlier two methods. All assets, liabilities, income and expenditure are fairly stated if this method is followed. Besides, the inherent advantages of this method, it has also got some legal sanctity. The ICAI has also recommended this method in its Technical Guide on Accounting and Auditing in Not-for-Profit Organisations, issued in February 2003. It has been provided that "*Since not-for-profit organisations receive a large volume of grants to meet certain revenue expenses, it is recommended that both the grant (to the extent utilised during the period) and the relevant expense should be disclosed separately in the income and expenditure account. Such a disclosure would be useful in appreciating the operations undertaken by the NGO during the period.*"

Income and Expenditure account	
Income	Amount (Rs. Lakhs)
Grants	20
Less: Unspent	10
Donations	5
Total Income (a)	15
Expenditures:	
Development Expenses	10
Other Expenses	2
Total Expenditures (b)	12
Net Surplus (a-b)	3

Balance Sheet	
Sources of funds	Amount (Rs. Lakhs)
Corpus fund	10
Surplus	3
Unspent grant	10
Total	23
Application of funds	
Fixed Assets	10
Investments	12
Current Assets	1
Total	23

Applicability of Accounting Standards

Regarding applicability of Accounting Standards to NGOs, the Accounting Standard Board (ASB) has given an opinion in September 1995. The relevant text of the opinion is reproduced below:

"The Institute will issue Accounting Standards for use in the presentation of the general purpose financial statements issued to the public by such commercial, industrial or business enterprises as may be specified by the Institute from time to time and subject to the attest function of its members"

The reference to commercial, industrial or business enterprises in the aforesaid paragraph is in the context of the nature of activities carried on by an enterprise rather than with reference to its objects. It is quite possible that an enterprise has charitable objects but it carries on, either wholly or in part, activities of a commercial industrial or business nature in furtherance of its objects. The Board believes that Accounting Standards apply in respect of commercial, industrial or business activities of any enterprise, irrespective of whether it is profit oriented or is established for charitable or religious purpose. As, will not, however, apply to those activities, which are not of a commercial, industrial or business nature. (E.g. an activity of

collecting donations and giving them to flood affected people).

It is also clarified that exclusion of an entity from the applicability of Accounting Standards would be permissible only if no part of the activity of such entity was commercial, industrial or business in nature. For the removal of doubts, it is clarified that even if a very small proportion of the activities of an entity was considered to be commercial, industrial or business in nature, then it could not claim exemption from the application of Accounting Standard. The Accounting standards would apply to all its activities including those which were not commercial, industrial or business in nature."

It is clear from the above that the Accounting Standards are applicable to NGOs whose some, or more, of the activities are commercial or business in nature. However, it is very difficult to determine what is the exact meaning of commercial or business activities with reference to NGOs. NGOs are not meant for earning profit out of their activities. Even if profit is derived from some of the activities the profit is ploughed back or returned to the beneficiaries. For example, if one of the objects of an NGO is to grant loans to micro credit institutions or self-help groups and some interest income is derived from the loans granted, will the activity be constituted as commercial in nature? Similarly, if an NGO provides its training or conference hall to some other organisations or institutions and charges rent from such organisations, which is utilised for other objects of the NGO, will it be constituted as commercial activity? Should Accounting Standards be applicable to such NGOs who derive income from such small income generating activities, which are not purely commercial in nature?

Intricacies Under Income Tax Act, 1961

There have always been some issues under

the Income Tax law, which have been subjected to different interpretations by the taxation as well as judicial authorities. Some of them are discussed below—

1. **Depreciation:** Tax authorities are reluctant to allow depreciation as deduction from the income of NGOs on the grounds that when capital expenditure is itself allowed as 'application' of income for the purposes of section 11 then allowing depreciation will amount to a double deduction. However, in *Director of Income Tax (Exemption) v. Franjee Cawasjee Institute* (1993) 109 CTR (Bom) 463 it was held that even if the

Tax authorities are reluctant to allow depreciation as deduction from the income of NGOs on the grounds that when capital expenditure is itself allowed as 'application' of income for the purposes of section 11 then allowing depreciation will amount to a double deduction.

capital expenditure on acquisition of asset is treated as application for the purposes of section 11, depreciation is allowed as deduction. Similarly, in *Eight ITO v. Trustees of Marathi Mission* (1982) 1 ITD 539, the Bombay Tribunal held that depreciation claim is allowable even if the assessee trust does not carry on any business and the entire cost of assets has been allowed full deduction. However, for deriving 'income' for the purpose of section 11 of the Act, depreciation is treated as 'application'. It was held in *CIT v. Society of Sister of St. Anne* (1984) 146 ITR 28 (Kar) that it is not right to contend that the depreciation, being a notional expenditure, cannot be allowed to be debited to the expenditure account of the trust.

'Income' for the purposes of section 11 is to be arrived on normal commercial principles and

in popular or general sense. In *CIT v. Sheth Manilal Ranchhoddas Vishram Bhavan Trust* (1992) 198 ITR 598 (Guj), it was held that though the income of the assessee trust was assessable under the head house property, depreciation debited to the accounts was allowable.

In *CIT v. Raipur Pallotine Society* (1989) 180 ITR 579 (MP), it was held that depreciation has to be allowed as a deduction to preserve the corpus of the trust.

2. **Income:** What constitutes income for the Income tax purposes has been a matter of controversy since the inception of the definition of 'income' under the Income Tax Act. Section 2(24)(ii) of the Income Tax Act, 1961 defines 'income'. It provides that 'income' includes voluntary contributions received by charitable or religious trusts or such institutions, scientific research associations or sports associations. Voluntary contribution received by funds or trusts or institutions is exempted under section 10(23C)(iv) and 10(23C)(v) also constitutes income of such fund or trust or institution. Thus, income of NGOs may be in the form of donations, voluntary contributions from members, subscription fees, capital gains, profit and gains from business carried on by the organisation, income from property held under trust and corpus donations. Corpus donations do constitute income for the purposes of section 2(24)(ii) but this section has to be read with section 12 which provides that contributions made with specific directions that they shall form part of corpus of the trust are not included in income of the trust or institution.

It was held in *CIT v. Rao Bahadur Calavala Cuna Chetty Charities* (1982) 135 ITR 485 that the word 'income' used in section 11 is to be understood in general commercial or popular sense.

The word 'income' under section 11(1)(a) and the word 'total income' defined under sec-

tion 2(45) have different meanings vide CBDT's Circular No. 5P (LXX-6) dated 19th June 1968. Similar was decision in *CIT v. Birla Janahit Trust* (1990) 208 ITR 372 (Cal.). It was held in *CIT v. Trustees of H.E.M. Nizam's Supplemental Religious Endowment Trust* (1981) 127 ITR 378 (A.P.) that for purposes of section 11, income is derived from books of accounts and only such income which is left after expenditure has to be taken into account.

Amount of tax deducted at source not received by the assessee cannot be treated as income for the purpose of application under section 11. [*CIT v. Jayshree Charity Trust* (1984) 159 ITR 280 (Cal.)]

For accumulation purposes, 'income' means the gross income derived from property held under trust. It is 25 per cent (now 15 per cent) of the income derived from property held under trust, which is available for accumulation. In *CIT v. Programme for Community Organisation* (2001) 248 ITR 1 (SC) the Hon'ble Supreme Court has held that a charitable or religious trust is entitled to accumulate 25 per cent (now 15 per cent) of its income derived from property held under trust, and the contention that the trust is allowed to accumulate only twenty five percent of the unspent balance available after deducting expenses was rejected.

Issues Under Foreign Contribution Regulation Act, 1976

The FCRA 1976 was originally focused on political parties and the involvement of foreign funds in Indian elections. It was much later that the focus shifted towards the NGOs. Currently, it is the basic law that governs the foreign funding and its utilisation. However, there have always been some issues of controversies under the present FCRA. These issues range from what is foreign source to how recoveries under foreign funds are to be accounted for under the financial statement of the NGOs.

1. Foreign Source

(i) Section 2(e) of the FCRA, 1976 defines the term 'foreign source'. This is an inclusive definition but not an exhaustive one. There have always been divergent views regarding contributions from certain kind of individuals and agencies.

- *Indian citizens living abroad:*

Clause (x) of sec. 2(e) provides that donations from a citizen of foreign country is deemed to be a 'foreign source'. This means that although a person may be living in a foreign country, but his donations to India will not be considered as a foreign source until and unless he gets a foreign citizenship. This means that irrespective of the period of stay of an Indian citizen abroad, his contribution will remain as Indian source and will not be treated as 'foreign source' under FCRA.

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- *Non-Resident Indians (NRIs):*

An Indian can become Non-Resident due to his period of stay abroad yet he doesn't become a foreign citizen by becoming an NRI as Non-Resident and foreign citizenship are two separate and distinct concepts. Thus, contributions from NRIs are not treated as a 'foreign source' until they become foreign citizens.

- ***Subsidiaries of foreign companies formed in India:***

Contributions from companies of foreign countries are treated as a 'foreign source'. Similarly, contributions from their subsidiaries formed outside India are also treated as 'foreign source'. For subsidiaries formed and registered in India, Sec. 2(e)(iii) provides that such subsidiaries of foreign companies formed in India are also 'foreign sources' and contributions from such subsidiaries, although formed and working in India, are foreign contributions within the meaning of FCRA.

- ***International agencies:***

By virtue of sub-clause (ii) of clause (e) of section 2 of the Act, all international agencies are treated as foreign source except United Nations Organizations, UN Specialized Agencies, The World Bank and International Monetary Fund. Besides these, the Central Government has power to exempt any international agency from being treated as 'foreign source' by notifying such agency in the Official Gazette. Similarly a foreign institution, which has been permitted by the Central Government by its notification in the Official Gazette to carry on its activities in India, is not treated as 'foreign source'.

2. **Recoveries under foreign funds:**

Sometimes, NGOs recover some nominal amount from the individual beneficiaries who are provided certain services, items etc., at a subsidised rate. The reporting of receipt of such money mainly depends upon the funding of the related expenditure on such items, services etc. If the related payment to purchase such items or hire such

services is from foreign funds, then such recoveries should be reported as foreign contribution money only and must be reported in FC-3. If the related expenditure has been made out of both Indian and foreign funds then the recoveries should also be bifurcated into Indian and foreign on the basis of related incurrence of expenditure.

3. **Overhead Cost Charged on Projects:**

An NGO may many times charge certain overhead costs like rent of premises hire charges of vehicles, etc., from certain projects according to the project terms and conditions and may get the reimbursement of such costs from the project itself. Accounting of reimbursement of such funds under FCRA depends on where the related asset is situated. If the asset is shown in foreign Balance Sheet then the related recovery must be shown in foreign account only. Thus the reporting of the income from such assets depends upon the initial funding and accounting of such assets, in Indian or foreign Balance Sheet. The general rule is that if there is any income from the assets acquired out of foreign contribution or its funds the same goes to foreign contribution accounts only.

Conclusion

Because of diverse practices being followed by NGOs for preparation of financial statements, there is an immediate need for consolidating the entire gamut of issues under one umbrella, either, in the form of a Guidance Note or a Financial and Reporting Standard, so that the goal of uniform accounting practices and better presentation of financial statements can be achieved. The State shall also bring out some clarifications or explanations regarding the disputable issues under different laws so that a consensus can be achieved and preserved. □