CONCEPT NOTE ON NOTIONAL EXPENDITURES IN DEVELOPMENT PROJECTS IN GRANT BASED FORMS OF CO-OPERATION

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1. UNDERSTANDING NOTIONAL EXPENDITURE

1.1. In this concept note we shall be discussing the concept and prevailing practices of Notional expenditures in development projects.

1.2. The recognition of an expense in a Financial Statement as per the "Framework for Preparation and Presentation of Financial Statements" issued by ICAI in Para 93 "Expenses are recognized in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase of liabilities or a decrease in assets (for example, the accrual of employees' salaries or the depreciation of plant and machinery)."

1.3. Similarly, the Guidance Note on Terms used in Financial Statements issued by ICAI in clause 5.04 defines expenditure as "Incurring a liability, disbursement of cash or transfer of property for the purpose of obtaining assets, goods or services."

1.4. In context of the above definitions the notional expenditure is that expenditure <u>which remains unutilized or accrued</u> at the organization level even though it has been shown as utilized to the donors at project level through charging of <u>expenditure where there was no actual cash outflow.</u>

1.5. For example, if an organisation charges rent in a particular project for the use of its own premises, such rent will result in a notional expenditure in that particular project and at the same time will result in a notional income in the general fund / account of the organisation. Similarly notional expenditures can be created by various methods including charge of expenditure on approximate basis or even inflating the expenses.

1.6. Notional expenditure/income could also happen in case the grant recipient makes disbursement in cash to itself by transferring funds from one bank account to another. In such case the payment would become expenditure although the organization is still getting an income.

1.7. Notional expenditure generally is also valued at the estimated difference between the market value of the goods or services provided and the actual cost incurred by the party.

1.8. It has been seen that some donors permit notional expenditure as a basis for recovering administrative expenses. For instance, a project budget may be allowed 10% of the project cost as administrative charge. In such circumstances, the organisation will collect 10% of the project cost as administrative expenses but the actual administrative expenditures may be higher or lower than the amount charged.

1.9. In normal accounting parlance, certain legitimate non cash expenditures are also referred to as notional expenditures. Depreciation is an example of such non cash notional expenditure. In case of depreciation the term notional may not be entirely relevant because it actually denotes the wear and tear or the loss in the value of the asset. However, in development projects, normally non cash expenditures are not considered as a part of the budget as the project assets are also financed under the project cost. Therefore, the possibility of charging further depreciation to the same project does not arise.

2. NOTIONAL EXPENDITURE FURTHER ELABORATED

2.1. The expenditure can be said to be notional when the expenditure is accrued at the organization level even though it has been shown as utilized to the donors at project level through charging of expenditure where there was no actual cash outflow.

2.2. In a grant contract the recipient organization holds the grants as a “Trustee”. It is a well established principle that a trustee should not derive profits or gains from the funds held in trust. In many grant contracts there are clear laid down conditions for the utilization of the same. Certain unacceptable practices which result directly in benefitting the “trustee” organization may also tantamount to a form of corruption or fraud.

2.3. An example would make it much more clear. There is a cost attached to a particular service and then there is a market value of the service. If a particular service is charged at cost by the trustee organization to the restricted grant, then there is no accrual of surplus. If the market value is higher than the cost and the organization charges the market value to the restricted grant, then there is a surplus which accrues to the organization and that is transferred to General Reserve/Fund of the organization. Further, if the organization charges the grant/project higher than the market value, then also the accruals will be treated as notional expenditure.

2.4. In cases where through charging of notional expenditure as described in 2.3, if the benefit goes to a particular person or group of person outside of the organization, then it would amount to fraud.

3. DIFFERENCE BETWEEN COMMERCIAL CONTRACT & NPO PROJECT CONTRACT

3.1. In a commercial contract generally a client is billed against invoices at a pre-determined rate of goods and services. For example, a commercial organisation may charge @5000/- per person per day but the actual expenditure may be much less than Rs.5000/- per day. In such cases, the commercial organisation will book actual expenditures against such receipts and the profit and loss shall be automatically determined at the end of the year. However, in the case of an NPO, expenditures are charged at an estimated rate of, say, Rs. 5000/- to the project which may be much more than the actual expenditure, then it will result in notional expenditure as well as notional income. This is because the utilisation statement has been prepared on the basis of the estimated rate and not the actual expenses and being a nonprofit organisation, profit cannot be booked.

3.2. It may also be noted that, all NPO projects are subject to actual utilisation of funds. Therefore, in a project contract estimated or notional expenditure should not be booked as actual utilisation of funds. If estimated or notional expenditures are booked as actual expenditures, then, funds are not actually applied to that extent and would tantamount to diversion of project funds.

4. WHY LEGALLY NOTIONAL EXPENDITURE IS NOT PERMISSIBLE

4.1. To incur a valid expenditure, it is necessary that there is a valid transaction between two parties. All expenditures to be legally valid would require a valid legal transfer of funds against valid invoices for goods or services. It is an established legal dictum that one cannot trade or transact with oneself. Therefore, whenever there is a transfer of funds from one project to the general fund or another project, the fact remains that there is no legal transaction as far as the organisation as a whole is concerned. The inter project transactions get nullified at the time of consolidation.

4.2. For Example: An NGO charges Rs.200/- per head towards the food provided to the participants in a Seminar conducted at its own building. The NGO transfers Rs. 10,000/- to its general fund from the project account as expenditure against fooding of participants. However, in its general account the actual expenditure against fooding is Rs.4, 000/- only. Therefore, there is a profit of Rs.6, 000/- in a general account. In this case, in the project account Rs. 6,000/- was charged over & above the actual expenditure. Therefore there is a profit of Rs.6, 000/- in the general account. In other words, the NGO as a legal entity does not gain or lose anything but there is a loss of Rs.6, 000/- in one project and gain of Rs.6,000/- in the general account i.e. transferring funds from one pocket to another. Further, for greater clarity the following are characteristics of such a transaction:

4.2.1. The service provider and the recipient are the same person.

4.2.2. No legal transaction or transfer with oneself

4.2.3. There is a notional charge of expenditure in one project to the extent of Rs. 6,000/-

4.2.4. There is a matching notional profit in general account to the extent of Rs. 6,000/-.

4.2.5. For donor utilisation purposes, the utilisation statement shall be inflated to the extent of Rs. 6,000/-. However the consolidated accounts will show the correct expenditure as only actual expenditure is permissible under the income tax and FC laws. Therefore, Rs.6, 000/- will be transferred from the project account to the general account without any legal implications.

5. COMMON PRACTICES OF NOTIONAL EXPENDITURE

5.1. Some of the common practices of notional expenditures in the NPO sector are as under:

5.1.1. Charge against use of own building

5.1.2. Charge against use of infrastructure, convention centre etc.

5.1.3. Charge against use of vehicle

5.1.4. Charge against use of photocopier, telephone, computer etc.

5.1.5. Providing services at a pre determined rate

5.1.6. Charge of salary of the same staff to various projects.

5.2. In the following paras some case studies and methodology of various common practices of notional expenditure have been discussed.

6. GOODS AND SERVICES PROVIDED AT A FIXED RATE

6.1. There are instances where the organisation provides goods and services at pre- determined prices. For instance, the organisation may charge for food against number of participants in meetings and training at a fixed pre-determined rate whereas the actual expenditure may be much lower.

Similar to the example discussed earlier, XX NPO conducts training and conference for the beneficiaries throughout the year. Its trainings are generally residential inclusive of food and accommodation. All participants stay in the building owned by XX. XX charges Rs. 200/- per day per participant towards food and Rs. 300/- towards accommodation. The money charged to the project is transferred to the general account. The actual expenditure on food and maintenance of property is incurred from the general account. It was found that the actual expenditure was Rs. 100/- per day per participant towards food and Rs.100/- towards accommodation. In this case, XX has charged notional expenditure of Rs.100/- per day per participant towards food and Rs.200/- towards accommodation.

6.2. The above example shows charging of notional expenditure which is not an acceptable Practice in a project contract. The expenditure is not actual to the extent transferred to the General Fund. A partner organisation is not allowed / supposed to make profit from development projects. From a legal perspective also such expenditures are not permissible since the law would allow only the actual expenditures as one cannot trade with itself. In such cases, one project of the partner is the service provider and another project is the service recipient which is legally not permissible.

7. RENT AND SERVICE CHARGE AGAINST ASSETS

7.1. There might be instances where the organisation charges the project against use of its assets. The assets could be land and building, training and conference facilities, vehicles, telephone, photocopier etc. The following points needs to be kept in mind:

7.2. **If the charge is against use of the building, it should be seen whether the building is owned or rented:** In case the building is owned by the organisation, it should be clarified whether the building has been created out of corpus funds or accumulated reserves or any other sources. The building or property even though owned by the NPO may have been created out of project funds also. Therefore, one may be subjected to three types of circumstances where rent or charges are collected against building or property:

I. Building or property created out of corpus funds or accumulated reserves
II. Building or property created out of the project funds or from past projects of the same donor.
III. Building or property created out of funds provided by other donors.

7.3. **Rent in case of self owned property created out of corpus funds or accumulated reserves:** Any recovery made against such assets should be transparently disclosed at the project proposal stages and should be formally reflected in the project agreement. Further, the rent/charges recovered should be comparable with the reasonable market rent. In such cases, it is necessary to assess the purposes for which the building is used i.e. for programme or administrative purposes. Further, normally, it is expected that the NPO should also contribute to the project. Therefore the clarity and rationale for such transaction needs to be established between the donor and the NPO.

7.4. **Rent in case of self owned property created out of the project funds or from past projects of the same donor:** No recovery should be made against use of such assets for project purposes. However, actual reasonable expenses on maintenance and upkeep of the property can be charged if it is used for the project purposes. This should be provided for in the budget itself. The implementing partner should declare that no notional expenditure have been charged against the assets funded by the same donor.

7.5. **Rent in case of self owned property created out of funds provided by other donors:** Normally no recovery should be made against use of such assets for project purposes. However, if there is a circumstantial justification for use of such assets, then the rent or cost charged against such assets should be transparently disclosed at the project proposal stages and should be formally reflected in the project agreement. Further, the rent/charges recovered should be comparable with the reasonable market rent.

7.6. **Rent against other infrastructure and assets such as training facilities, equipments etc.**: When an organisation recovers the cost of the assets owned by it, then it becomes important that such cost recovery mechanism is transparently disclosed at the project proposal stages and is formally reflected in the project agreement. Any internal recovery/ gain by the organisation is not permissible unless it is formally approved by the donor. The same rationale of the source of such assets is also applicable i.e. whether such assets are corpus assets or project assets needs to be seen and the treatment should be as discussed above with regard to self owned property.

7.7. **Multiple Rent in case of a rented building:** It should be ensured that the sum total of the rent charged to various projects does not exceed the total actual rent paid. If the rent charged to various projects exceeds the actual rent, then it will result in notional expenditure as well as income for the organisation.

7.8. **Rent in case of self owned car/vehicle, photocopier and other assets:** The same principle should be applied as have been illustrated in context of self owned building or properties. Further, the rent charged should be comparable with the reasonable market rent and the permission from the donor in this regard should also be obtained at the proposal stages.

7.9. **Rent and other charges paid to sister concerns of the organisation:** Such conflict of interest transactions should be done with prior approval of the donor and should be declared and disclosed. Such transactions may also be in violation of the provisions of the local laws such as the Income Tax Act in India.

8. ADMINISTRATIVE EXPENDITURE AS A FIXED CHARGE

8.1. There might be instances where the organisation charges the administrative expenses as a fixed charge i.e. the organisation may charge 20% of the project cost as administrative expenditure. In such circumstances, the project agreement needs to be adhered to for the approval of the donor in this regard. Any other administrative expenditure which is charged to the project over and above the fixed administrative charge is not admissible.

8.2. Some donors might permit such charges for some small or specific projects. However, legally such charges do not constitute valid expenditure and therefore, it is not permissible to treat such expenditure as valid utilization of project funds.

9. INFLATING SALARIES TO CREATE BOTH NOTIONAL INCOME AND EXPENDITURE

9.1. There might be instances where the organisation charges inflated salaries and subsequently the additional amount charged to the project is transferred to the general fund by creating notional income. This is not an acceptable practice. The case study in the box will clarify the issue further.

YY NPO is having ten staff and pays Rs.1, 00,000/- per staff per month. However, in the project, the salary is charged @ Rs.2, 00,000/- per staff per month. On the same day of the salary payment, all the staff make donation of Rs. 100,000/- back to the organisation. In this way, YY is able to transfer Rs. 10, 00,000/- per month to its general funds by charging notional expenditure in the project and by showing notional income in the general account.

9.2. Apart from the above example, there may be various illegal or unfair ways in which payment of salaries could be charged to various projects. Some instances are as under :

9.2.1. Charging the salary of the same staff to more than one project, where the sum total of the amount charged is more than the amount actually paid.

9.2.2. The same staff taking two or more salaries budgeted in the project proposal by formally executing multiple fulltime tasks.

9.2.3. Payment of salaries to core staff and functionaries not related with the project or working under some other project.

9.2.4. Transferring the budgeted salaries to the general fund and paying lesser salary to the staff from the general fund etc.

10. INFLATING PROGRAMME EXPENSES TO CREATE BOTH NOTIONAL INCOME AND EXPENDITURE

10.1. There might be instances where the organisation charges inflated programme expenditures and subsequently the additional amount charged to the project is transferred to the general fund by creating notional income. This is not an acceptable practice. The case study in the box below will clarify the issue further.

ZZ NPO is distributing funds among beneficiaries for purchase of seeds and manure. It pays Rs.10, 000/- per beneficiary for 100 persons. However, on the same day of the payment to the beneficiaries, all the beneficiaries make donation of Rs.5, 000/- back to the organisation. In this way ZZ is able to transfer Rs.5, 00,000/-to its general funds by charging notional expenditure in the project and by showing notional income in the general account.

11. CHARGING COMMON EXPENDITURE TO VARIOUS PROJECTS

11.1. There might be instances where the organisation charges common expenditure to various other projects. The common expenditure may be rent of premises, brochures and materials for similar programme etc. It may be noted that if the common expenditure has been already funded by one particular donor, the same expenditure should not be charged again to various other projects and donors.

11.2. In case the common expenditure is shared by various donors, it needs to be ensured that the sum total of the expenditures charged to various projects is not more than the actual expenditure incurred by the organisation. The policy of apportionment must be reasonable and logical, it must be formally decided within the organisation. Further, it must be ensured that it has been budgeted in the project. In various instances, it has been found that the same programme or activity has been shown as expenditure to more than one project. In such circumstances it is important to ensure that if two projects of similar activities are implemented, then there should be adequate disclosure and internal control with regard to double booking of expenditures.

12. CREATING PROVISION FOR EXPENDITURE & SUBSEQUENTLY TRANSFERRING IT TO GENERAL FUND

12.1. There might be instances where the organisation creates provision for expenditure and charges it to the project. In other words, the reporting to the donor reflects a notional expenditure which is just the provision and has not been actually incurred. In the subsequent year, the same provision may be transferred as surplus to the general fund by reversing the entry. Wherever non cash expenditure is incurred or expenditure is charged based on accrual basis of accounting (i.e. where the cash is s till with the organisation but utilisation is shown to the donor), it needs to be ensured that the amount so provided is actually paid out in the subsequent year.

13. CHARGING NOTIONAL CONVEYANCE AND ALLOWANCES AGAINST STAFF

13.1. There might be instances where the organisation charges notional amount as conveyance allowance and other reimbursements to staff. In other words, there is no actual expenditure but a considerable amount is charged to the project against various staff as daily conveyance, refreshment allowance and other permissible unsubstantiated expenditures. It needs to be ensured that there are no notional expenditures and matching notional income in this regard.

14. CONCLUSION

14.1. In a grant based contact, care has to be taken to ensure that only actual expenditures are charged to the project.

14.2. In case of any assets or infrastructure being used for project purposes, it has to be first discussed with the donors and based on the agreement reached, other costs of maintenance can be covered out of project funds or rate for usage can be charged.

14.3. It has to be ensured that common expenses are apportioned in a reasonable and logical manner. Under no circumstances, the expenses can be charged twice to different projects.

14.4. Since the relationship between the donor and the NPO is based on mutual trust, care should be taken to ensure that there is enough transparency so that issues like notional expenditure are clearly discussed, understood and agreed upon.

14.5. The procurement rules and regulations should be clearly defined by the donor agency so as to avoid the chances of Organization applying its own methods.

14.6. Utilization statement to be made on the basis of actual utilization supported by bills/invoices.