NYSCHP FINANCIAL MANAGEMENT: Accounting for Nonprofits

Accounting basics

An accounting system is comprised of accounting records (checkbooks, journals, ledgers, etc.) and a series of processes and procedures assigned to staff, volunteers, and/or outside professionals. The goals of the accounting system are to ensure that financial data and economic transactions are properly entered into the accounting records and that financial reports necessary for management are prepared accurately and in a timely fashion.

Traditionally, the accounting system includes the following components:

Chart of Accounts

The chart of accounts is a list of each item which the accounting system tracks. Accounts are divided into five categories: Assets, Liabilities, Net Assets or Fund Balances, Revenues, and Expenses. Each account is assigned an identifying number for use within the accounting system.

General Ledger

The general ledger organizes information by account. The chart of accounts acts as the table of contents to the general ledger. In a manual system, summary totals from all of the journals are entered into the general ledger each month, which maintains a year-to-date balance for each account.

Journals and Subsidiary Journals

Journals, also called books of original entry, are used to systematically record all accounting transactions before they are entered into the general ledger. Journals organize information chronologically and by transaction type (receipts, disbursements, other). There are three primary journals:

- The Cash Disbursement Journal is a chronological record of checks that are written, categorized using the chart of accounts.
- The Cash Receipts Journal is a chronological record of all deposits that are made, categorized using the chart of accounts.
- The General Journal is a record of all transactions which do not pass through the checkbook, including non-cash transactions (such as accrual entries and depreciation) and corrections to previous journal entries.
- The Payroll Journal, which records all payroll-related transactions. This may be useful as the number of payroll transaction s grows and becomes too large to handle reasonably within the cash disbursements journal.
- The Accounts Payable Journal and Accounts Receivable Journal track income and expense accruals. These are useful for grouping income and/or expense accruals which are too numerous to track effectively through the general journal.

The process of transferring information from the journals to the general ledger is called posting.

Checkbook

In very small organizations, the checkbook may serve as a combined ledger and journal. Most financial transactions will pass through the checkbook, where receipts are deposited and from which disbursements are made. Smaller organizations receiving few or no restricted contributions find it easier to keep track of financial activity by running all of their financial transactions through a single checking account. Very small organizations, with few deposits and disbursements, may prepare reports directly from the checkbook after the balance has been reconciled with the bank balance.

Accounting Procedures Manual

The accounting procedures manual is a record of the policies and procedures for handling financial transactions. The manual can be a simple description of how financial functions are handled (e.g., paying bills, depositing cash and transferring money between funds) and who is responsible for what. The accounting procedures manual is also useful when there is a changeover in financial management staff.

The accounting cycle may be represented schematically as follows:

financial transactions -> analyze transaction -> record transaction in journals -> post journal information to general ledger -> analyze general ledger account and make corrections -> prepare financial statements from general ledger information

The routine aspects of the accounting cycle (recording transactions, posting, etc.) are generally done by bookkeepers or data entry clerks. Accountants focus on the more analytical aspects of the accounting cycle (analyzing transactions, preparing financial statements.) Many small organizations rely on a single individual to perform all of these functions.

The key tasks for maintaining the integrity of an accounting system include the following:

Trial Balance

In a manual system all balances from the general ledger are tallied on a monthly basis to make sure that debit balances equal credit balances. Once debits equal credits, financial statements can be prepared using trial balance amounts.

Bank Reconciliation

Each month you will need to reconcile the balance in your checkbook with the balance in your account according to your bank. This process has three basic steps:

1. Compare deposits and checks as they are recorded in the checkbook with those reflected in the bank statement. Adjust any discrepancies.
2. Adjust for bank charges or interest earned into the checkbook balance.
3. Subtract uncashed checks from the bank s balance and add in checks you have deposited which are not yet reflected in the bank's balance.

Executive Directors and board members must ensure that there is enough money in the bank to pay the bills each month. Cash flow must be planned and programs must be based on the availability of funds.

- *What is cash flow and how should we manage it?*

"Cash flow" management refers to the need to have cash come in -- flow in -- at the right times, so that it is available to flow out as needed. Everyone knows that if an organization has more expenses than income, sooner or later it will find itself in trouble. However, even if income matches or exceeds expenses in a given year, the cash from the income may not arrive in time to pay the bills as they come due. A cash shortage can be very disruptive to your ability to carry out your mission. To avoid disruptions of business or to take advantage of temporary cash surpluses, cash flow can and should be projected, monitored, and controlled.

Chart of Accounts

A Chart of Accounts is a list of items that you want to track through the accounting system. For example, do you want to track office supplies, or do you want to track paper, pens and ink? You will need to decide the answer to this question before you develop your accounting system. Some funders or governments require that you report about certain items so check out these two web sites and develop a good, useful Chart of Accounts.

- *What should our chart of accounts include?*

In order to decide what to include in your chart of accounts you will want to consider each of the following questions:

What reports do you want to prepare? What financial decisions, evaluations and assessments do you need to make on a regular basis? What level of detail do you require? What is your capacity for tracking financial information?

- ***Assets***
  Assets are the tangible items an organization has as resources, including cash, accounts receivable, equipment and property. Assets are usually listed in descending order of liquidity. This means that cash and other assets which are easily converted to cash are listed first, and fixed assets such as property and equipment are listed last.
- ***Liabilities***
  Liabilities are obligations due to creditors, such as loans and accounts payable. Current liabilities, those obligations which fall due within the next year, are usually listed first, followed by long-term liabilities. Accounts payable and payroll taxes payable are usually listed before other payables. Deferred revenue and other liabilities are often further down on the list.
- ***Net Assets (or Fund Balances)***
  Net assets, formerly referred to as the fund balance(s), reflect the financial worth of the organization. They represent the balance remaining after obligations are subtracted from an organization's assets. Accounting software designed with for-profits in mind may report net assets under the heading "equity."

- You will notice that account numbers proceed from lowest to highest, with room between numbers in each category. This allows you to expand the level of detail presented in the chart of accounts as your activities grow. Certain related accounts are grouped together with related numbers.

Financial Reports

Financial information must be reviewed and understood by staff and board members. Good financial reports give the relevant information to the right people at the right time so that they can make sound business decisions. The reports should include information from the Revenue and Expense Statements and the Balance Sheet.

- *What financial reports do management and the Board need?*

Monthly Reports

- Statement of Position (Balance Sheet)
  What is our financial health? Can we pay our bills?
- Statement of Activities (consolidated) showing budget to actual information
  What has been our overall financial performance this month and to date?
- Departmental Income and Expense Statement showing budget to actual information
  How does actual financial experience compare with the budget? Is specific action called for, such as limiting expenses in certain areas? Does experience indicate a change in the budget is appropriate?

Quarterly Reports

- Fundraising Reports; actuals vs. projections for donations; status report on all foundation proposals.
  Are fundraising results on track?
- Cash flow projections for the next six months
  Do we anticipate a cash surplus or shortage?
- Payroll tax reports
  Have payroll tax reports been submitted on time and tax deposits been made?
- Fee for service report showing number of fee-paying clients and revenue against projections?
  Are we servicing approximately the same number and type of clients as we had anticipated? If not, what action or change is appropriate?

Annual Reports

- Annual Federal forms, including 990 and Schedule A; State Reports
  Has the organization fulfilled its reporting responsibilities to federal and state governments?
- Draft financial statements for year: Statement of Activities; Statement of Position; Income Statement for each program. Aggregated financial statements with narrative showing key trends
  Focus: Internal management decision-making. What was our financial performance over the past year? In what ways and for what reasons was performance different from the budget? What financial implications must be taken into account when planning the upcoming year?
- Audited financial statements for the entire organization, including Statement of Position, Statement of Activities, Statement of Cash Flows, Statement of Functional Expenses
  Focus: External accountability and financial disclosure to funders and the public
- Management letter from the auditor
  What recommendations has the auditor made related to the accounting system, internal controls, and financial planning?

Who Prepares These Reports and Who Should Review Them?

In a small nonprofit the board treasurer or outside accountant/bookkeeper might prepare the financial information for all in-house financial statements, and work with the executive director to prepare the narrative with financial highlights to be presented to the board.

The executive director reviews all reports prior to presenting them to board members to ensure that the financial information makes sense and can be translated into issues and opportunities facing the organization. In addition, key staff members such as program directors and the director of development should have the opportunity to review income and expense reports for the whole organization.

When the board is large enough to include a finance committee, that committee reviews all financial statements and reports on financial activity to the full board. In a smaller nonprofit, the executive director might report first to the board treasurer, who can then keep the full board apprised of the organization s financial status.

The finance committee will often review the numbers in greater detail than the full board. The full board may be better able to respond to aggregated information with important financial trends and issues highlighted in an accompanying narrative report. While each board member should have the opportunity to review organization-wide income and expense reports to understand the impact their department's activities have on the whole organization, members who are inexperienced at reading financial statements may get lost in overly detailed statements. To help the board fulfill its oversight function, it is important for the executive director and the finance committee to present the information in as clear and concise a manner as possible.

How do we interpret our financial statements?

Readers of financial statements can learn a great deal about the health of a nonprofit organization by examining the numerical information presented. In particular, financial information helps readers:

- **Measure the organization's efficiency, using factors such as:**
  - Units of service produced compared to costs
  - Fundraising income compared to amounts spent on fundraising
  - Net income in a fee-producing program compared to the fees received

- **Evaluate the adequacy of financial resources, often through:**
  - Liquidity ratios, such as the current ratio
  - Comparison of total liabilities or total assets with net assets (formerly called fund balance)
  - Cash flow projections

- **Seek significant financial trends by:**
  - Vertical analysis (looking at a simple line item as a percentage of total revenue or expense)
  - Horizontal analysis (comparing prior periods with the current period)

For different organizations, different numbers will have different meanings. For example, imagine an organization that shows an operating deficit for the year of $20,000. Is that a red flag? In a small organization with few reserves, such a deficit may indeed indicate serious over-spending of failure to generate revenue. In a large organization, $20,000 may represent less than one percent of revenue and may not be significant. Yet another organization may be purposefully spending down cash reserves on an important program and this "deficit" may represent that decision. For still another organization, a loss of $20,000 may not be a concern by itself, but because it represents the third consecutive year of deficits, does cause concern.

Ratios, too, have different meanings in different situations. For example, a new organization may find it spent 90 percent of its dollars on fundraising. In an established organization, such a ratio would certainly be a red flag. But on closer look, this new organization's services are delivered by volunteers, and the only paid staff they have is a fundraiser.

Although accountants have determined certain standard ranges for these ratios within some nonprofit industries (arts, libraries, human service agencies, etc.), it is most important to identify the trends in your own organization and analyze changes over time.

Surplus or deficit

If income is greater than expenses within a given period, say a year, the organization has generated a surplus. If expenses are greater than revenue, the organization experiences a deficit for the period. There is no rule that says organizations should have surpluses, deficits, or break even. Typically nonprofits budget to break even. However, organization may deliberately decide to spend down their cash reserves (expandable net assets) for a specific purpose such as starting a new program. Doing so results in an operating deficit, but one which is planned. Similarly, if a nonprofit has determined that it needs a cash reserve for specific future purposes (cash flow, investing in a new program guarding against future declines in funding, etc.), the Statement of Activity should reflect an operating surplus. An "unplanned" surplus, deficit, or even a break even position should be analyzed to determine its causes and to plan for the implications.

Budget to Actual for Revenue and Expense

Perhaps the most commonly used financial indicator is a comparison of budgeted revenue to actual revenue, and budgeted expense to actual expense. These comparisons are made on both a monthly and a year-to-date basis. Significant variations from budget should be investigated to see whether new projections should be make based on actual experience, and/or whether managerial intervention is appropriate.

Functional Expense Ratios

When completing Federal Form 900, nonprofits must report expenses functionally, broken down into the categories of Program , Management and General Activities, and Fundraising. Donors and agencies who evaluate nonprofit performance, often look to see that most of your organization's funds are being used for programmatic purposes. As a result, it is important to develop consistent guidelines within your own organization to determine which of your expenses go to program support, and which to management and general activities or fundraising.

Some functional expense ratios are:

Program Expense and divided by Total Expense
If high, most of the expenses are related to program. Relatively little is spent on management or on fundraising.

Take Fundraising Expense and divided by Total Expense
If high, a large percentage of expenses are spent on fundraising efforts. Prospective donors may draw the conclusion that too high a portion of their contribution will be spent on fundraising, rather than on program services.

Short term liabilities coverage ratio (quick ratio)

Will there be enough cash to pay bills in the immediate or near future? Add together all assets that can be used to pay bills over a specific period of time, such as one month or three months and compare this with the bills that must be paid within that same period of time.

Take Cash + Unrestricted Investment + Accounts Receivable and divided by Current Accounts Payable + Current Accruals
If high, there may be too much in cash, some could be earning more if invested. If low, you may be in danger of a cash flow crisis, not enough cash to pay pressing bills.

Current Ratio

Will cash flow be adequate to pay bills over the next year?

Take the Current Assets and divide by Current Liabilities
If high, Same as above. Caution: Even if current ratio is adequately calculated for the year, there may be periods within the year where there is an inadequate cash to pay bills.

Deffered Revenue or Net Temporarily Restricted Assets

Deferred revenue traditionally refers to cash which has been received for some restricted condition which has not yet been met. Under the new Statement of Financial Accounting Standards No.116 issued by the Financial Accounting Standards Board (FASB), most of these funds will be held not as deferred revenue, but as an addition to temporarily restricted net assets.

To determine the ratio, take the Deferred Revenue and divide by the Cash + Savings - or - take the Temporarily Restricted Net Assets and divide them by the Cash + Savings.

If deferred revenue or temporarily restricted net assets exceeds cash and savings, you may be spending restricted cash for purposes other than those which the funder intended, or using monies designated for future purposes (such as magazine subscription fulfillment) to meet current expenses.

Fund Balance Ratio or Unrestricted Net Assets Ratio

The fund balance ratio, now called the unrestricted net assets ratio, measures the amount of unrestricted, spendable equity to the organization's annual operating expense.

To determine the ratio, take Expendable Unrestricted Net Assets and divide them by Annual Expenses.

If low, the organization has little unrestricted, spendable equity available to meet temporary cash shortages, an emergency, or deficit situation in the future. This may be the case even in organizations with significant unrestricted net assets, if the major portion of equity is tied up in fixed assets.

Days Receivables

The days receivables ratio measures the average number of days it takes to collect on a sale or service performed for a fee. This ratio is useful to organizations which earn significant portions of their revenue from fees charged to clients or from product sales.

To determine this ratio take the Accounts Payable times 365 days and divide by purchases.

If high, payments taking longer than 30 or 60 days are inconsiderate and may result in friction with community vendors. In addition, the organization may be incurring additional costs as a result of late or deferred payments (e.g., late fees, interest expense, etc.). A very long days payables ratio or a sudden increase in days payable may indicate an inability to pay bills.

Failure to Produce Financial Information

In order to assess the financial health of your organization, timely and reliable financial information must be available. Lack of adequate financial information may indicate that not enough time is available from staff or outside contractors to perform the accounting function, that staff needs more training in financial statement perpetration, or that financial systems need to be improved.

Final Comments

Ultimately, the most important performance measure of a nonprofit is not to be found in financial statements at all. To determine "success," a nonprofit must measure progress against its goals. It is important to remember that financial indicators are powerful tools for nonprofit managers, when used in pursuit of meaningful goals.

Audits

There are many good reasons to have an audit.

- An audit will ensure that financial records are in accordance with generally accepted accounting principles.
- An audit may be a good planning and budgeting tool for your agency.
- An audit may be a good public relations tool for what it says about your organization's financial integrity.
- An organization's granting agency may require an audit or may use the information in the audited financial statements when they evaluate the organization applying for funds.
- Lenders and suppliers may require it before credit approval.

- *What is an audit?*

An audit is a process for testing the accuracy and completeness of information presented in an organization's financial statements. This testing process enables an independent certified public accountant (CPA) to issue what is referred to as an opinion on how fairly the agency's financial statements represent its financial position and whether they comply with generally accepted accounting principles (GAAP). GAAP is determined by the American Institute of Certified Public Accountants (AICPA). Board members, staff, and their relatives cannot perform audits because their relationship with the organization compromises their independence.

The audit report is addressed to the board of directors as the trustees of the organization. The report usually includes the following:

- A cover letter, signed by the auditor, stating the opinion, as described above.
- The financial statements, including the statement of financial position (balance sheet), statement of financial activity (income statement), and statement of cash flows. Many audits show comparative information between fiscal years.

In addition to the materials included in the audit report, the auditor often prepares what is called a management letter or report to the board of directors. This report cites areas in the organization's internal accounting control system which the auditor evaluates as weak.

What an Auditor Does

The auditor will request information from individuals and institutions to confirm bank balances, contribution amounts, conditions and restrictions, contractual obligations, and monies owed to and by your organization. The auditor will review physical assets, journals and ledgers, and board minutes to ensure that all activity with significant financial implications is adequately disclosed in the financial statements. In addition, the auditor will select a sample of financial transactions to determine whether there is proper documentation and whether the transaction was posted correctly into the books. In addition, the auditor will interview key personnel and read the procedures manual, if one exists, to determine whether the organization's internal accounting control system is adequate.

Auditors are not expected to guarantee that 100 percent of the transactions are recorded correctly. They are only required to express an opinion as to whether the financial statements, taken as a whole, give a fair representation of the organization's financial picture. In addition, audits are not intended to discover embezzlements or other illegal acts.

Many auditors provide nonprofits with year-end financial management services which are not part of the audit. These include preparing:

- year-end financial statements based on client records
- notes to the financial statements
- depreciation schedules
- accrual and other adjustments based on client information

Smaller nonprofits with limited accounting expertise may choose to pay their auditors for these tasks. However, you should know that these services are provided in addition to the audit and can be completed by staff or volunteers to lower the cost of the audit.