Financial Management for Non-Profits
Terminology: What Do You Need To Know?

Accounting Period: Calendar Year or Fiscal Year

- **Calendar year:** An annual accounting period ending on the last day of December.
- **Fiscal year:** An annual accounting period ending on the last day of a month other than December.
- **Tax year:** The annual accounting period for which the Form 990 is being filed that coincides with the operating cycle of the organization, whether the calendar year ending December 31st or a fiscal year ending on the last day of any other month.

Accounting Methods: Cash or Accrual

- **Cash Method:** A method of accounting which records revenue when cash is received, and records expenses when they are paid.
- **Accrual Method:** A method which records revenue and expense when they are *incurred.*
- In the short term, the Cash method is easier, but in the long term, the Accrual method provides a better opportunity to assess an organization's financial health.

EXAMPLE: ABC Charity

ABC Charity has received a $25,000 donation for the past five years from 123 Company in December. On December 20th, they had not received the donation so the ABC Charity's Executive Director contacted the 123 Company. The 123 Company President said that the 123 Company was planning to make the donation, but had to wait until January to send ABC Charity the check.

With the cash method of accounting, the $25,000 donation is recognized when it is received in January. On December 31 in comparison to the previous year, the financial statement shows that donations are down and the year ended with a net loss resulting in a decrease in the charity's net worth.

With the accrual method of accounting, the $25,000 donation is recognized when the pledge was promised in December. On December 31 in comparison to the previous year, the financial statement shows that donations are stable along with the charity's net worth.

Chart of Accounts

The Chart of Accounts (COA) is a created list of the accounts used by an organization to define each class of items for which money or the equivalent is spent or received. The list can be numerical, alphabetic, or alpha-numeric. The name of each account should be unique and meaningful to allow it to be easily located and insure consistent posting of transactions.

Account Categories

Assets: Something that has been acquired or purchased that has monetary value.

- A **Current Asset** is cash or any asset that can be reasonably converted to cash within 1 year.
- A **Fixed Asset** is any item of value (land and buildings, motor vehicles, furniture, office equipment, computers, fixtures and fittings, and plant and machinery) and buildings, motor vehicles, furniture, office equipment, computers, fixtures and fittings, and plant and machinery) that cannot be easily converted to cash which the organization has bought or acquired and will use for an extended period of time.
- An **Intangible Asset** is a non-physical asset having a useful life greater than one year, i.e., trademark, lease agreement, patent, etc.
- **Other Assets** are miscellaneous assets that cannot be classified as current assets, fixed assets, or intangible assets.

Liabilities: Debts or obligations that must be paid.

- An **Accounts Payable** or **Accrued Expense** is an expense incurred but not yet paid.
- **Deferred/Unearned Revenue** is revenue received for a product or service before the product or service is delivered.

Net Assets (Fund Balances) are the unused funds represented by the difference between the total assets and total liabilities.

- **Unrestricted net assets** are funds unrestricted by the donor as to its terms and condition of usage.
- **Temporarily restricted net assets** are funds whose usage is limited by donor stipulations. These stipulations are temporary in the sense that the restrictions can either be removed by performing certain actions or can automatically expire over a certain time period.
- **Permanently restricted net assets** are funds where restrictions do not get removed or expire over a period of time.

Income (Revenue) is the total amount of money received by the organization for services provided and/or goods sold.

Expense is the money spent or cost incurred by the organization's to provide the services or goods.

Net income (Surplus/Loss) is the excess of income over expense, i.e., the amount remaining after all expenses are deducted from the income in an accounting period.

Financial Statements

Financial statements are a collection of reports about an organization's financial condition based on the organization's chart of accounts. Standard contents of a set of financial statements are:

- **Statement of Financial Position (Balance Sheet)**: Shows the organization's *assets, liabilities,* and *net assets* as of the report date.
- **Statement of Financial Activities (Income Statement):** Shows the results of the organization's operations and financial activities for the accounting period.
- **Statement of Cash Flows**: Shows changes in the organization's *cash flows* during the accounting period. ***NOTE: This presentation will not cover the Statement of Cash Flows.***

State-Mandated Financial Statement Reporting Methods: Compilation, Review or Audit

- The regulations governing the method of financial statement reporting is established at the state level; however, even if an organization is not mandated to have a review or audit conducted, the organization may still elect to do so.
- **Compilation (compiled financial statements):** A compilation is a presentation of financial statements that have been prepared by the organization and have not been reviewed or audited by an independent accountant.
- **Review of financial statement:** An examination of an organization's financial records and practices by an independent accountant with the objective of assessing whether the compiled financial statements are plausible, without the extensive testing and external validation procedures of an audit.
- **Audited financial statements:** Financial statements accompanied by a formal opinion or report prepared by an independent, certified public accountant with the objective of assessing the accuracy and reliability of the organization's financial statements.
    - **Audit:** A formal examination of an organization's financial records and practices by an independent, certified public accountant with the objective of issuing a report on the organization's financial statements as to whether those statements are fairly stated in accordance with generally accepted accounting principles (or other recognized comprehensive basis of accounting).

Federally-Mandated Financial Reporting Methods: Internal Revenue Service (IRS) Form 990, Form 990-EZ, or Form 990-N.

- **990-N** for organizations with *Income* normally less than or equal to $50,000;
- **990-EZ** for organizations with *Income* less than $200,000 and *Total Assets* less than $500,000;
- **990** for organizations with *Income* greater than or equal to $200,000 and *Total Assets* greater than or equal to $500,000.
- All organizations established as tax-exempt 501(c)3 public charities are required to file the applicable version of the Form 990. However, an organization may elect to file a more comprehensive form even if it does not meet the minimum requirements.
- The applicable 990 Form must be filed by the 15th day of the 5th month after the organization's accounting period ends, i.e., May 15th for an organization operating with a calendar tax year.

Functional Accounting

Functional Accounting is a method for tracking the real costs of program and supporting services. Expenses allocated to more than one service must be divided out according to their function. There are three functional expense areas: Program Services, Management & General Activities, and Fundraising Activities. Organizations that file the Form 990 are required to report expenses by functional classifications in the Statement of Functional Expenses.

Program Services Expenses are mainly those activities that further the organization's tax-exempt purposes.

Supporting Services Expenses, also known as *overhead* or *indirect* costs, are made up of management and general, fundraising and membership development activities.

- **Management and general activities** include general oversight, business management, general recordkeeping, budgeting, finance and other management and administrative activities.
- **Fundraising activities** include publicizing and conducting fundraising campaigns, maintaining donor mailing lists, conducting special fundraising events, preparing and distributing activities involved in soliciting contributions from individuals, foundations, government agencies, etc. Fundraising expenses should not be reported as program service expenses even though one of the organization's purposes is to solicit contributions.
- **Membership-development activities** include soliciting for prospective members and membership dues, membership relations and similar activities.

EXAMPLES OF SUPPORTING SERVICES EXPENSES:

Wages and benefits for persons involved in the general operation of the organization, such as: (i) Executive directors and other management; or (ii) Support personnel like secretaries, receptionists, and bookkeepers; and

Expenses related to (i) Providing an administrative office, including rent, depreciation, interest, utilities, taxes, insurance, and supplies; (ii) General management functions of the organization such as planning and budgeting, recruiting and training staff, and purchasing and distributing materials; (iii) Scheduling and conducting board, committee, and membership meetings; (iv) Publicizing the general organization; (v) Outside supporting services such as accounting, audit, and legal; (vi) Soliciting contributions or grants; and (vii) Any net loss from nongambling fund-raising activities.

Establishing a Cost Allocation Methodology

- **Direct costs** are expenses that can be identified specifically with an organization's activity or project, and can be assigned to a functional area with a high degree of accuracy.

- **Indirect costs** are costs that cannot be identified specifically with an activity or project.

> **EXAMPLE: Executive Director's Salary**
> *The salaries and expenses of the organization's chief executive officer and his or her staff should be allocated to Management and General Expenses, unless a part of their time is spent directly supervising program services or fundraising activities. In that case, their salaries and expenses should be allocated among management, fundraising, and program services.*

Expense allocation is problematical for all nonprofits and can be especially burdensome for smaller organizations because the method of allocation must be documented and available for review. This involves the establishment of a well-documented, organization-wide, cost allocation methodology.

1. **Describe** each allocated cost and explain how the expenses are allocated to the different functions.
2. **Establish** the basis for the allocation. Objective methods of allocating expenses are preferable to subjective methods. Expenses are allocated most commonly on the basis of:
    - **Direct-Staff Salaries/Hours:** Percentage of total salary of staff assigned to activities and/or percentage of time spent by staff assigned to activities.
    - **Direct Expenses/Modified Total Direct Expenses:** Percentage of total direct expenses for activities or percentage of total direct expenses for activities less distorting expense items (e.g., equipment purchases, flow through funds, etc.)
    - **Usage:** Percentage by usage of space, equipment, or other assets by activities.
3. **Review** the methodology at least annually and when there has been any significant change in the operation of the organization. The most common time to review the methodology is during the budgeting process and base the next year's allocations on the prior year actual percentages for activities.
4. **Decide** when to apply the allocations: 1) when the transaction is initially recorded in the accounting system; 2) during month-end report processing, and 3) during year-end processing. The most common time to apply the allocations is during the year-end process.

The initial year that the decision is made by the organization to use Functional Accounting and adopt a cost allocation methodology will be the most time consuming.

Financial Analysis

Financial Ratios are used to determine the condition of the organization. Financial Ratios are most helpful when comparing organizations of similar size and age, which are located in the same area or similar locales, and that have similar missions and programs. Financial Ratios are also helpful when tracking a specific nonprofit's progress over time.

1. **Program Ratio** = [program expenses] / [total expenses]: This shows how much is being spent on programs.

2. **Overhead Ratio** = ([management expenses] + [fundraising expenses]) / [total expenses]: This shows how much is not being spent on programs.

    a. **Management Expense Ratio** = [management expenses]/ [total expenses]: This shows how much is being spent on management in relation to total expenses.

    b. **Fundraising Expense Ratio** = [fundraising expenses] / [total expenses]: This shows how much is being spent on fundraising in relation to total expenses.

3. **Use of Contributions Ratio** = [contributions] / [program expenses] & 100-[contributions ratio]: This shows the percentage of contributions received that are being used for program services. If the percentage is 100% or less, then the 2nd percentage is the percentage of other sources of revenue or loss that are being used to provide program services, i.e., program fees and it means that 100% of contributions are being used to provide program services; if the percentage is greater than 100%, then the 2nd percentage is the percentage of contributions that are being used for expenses other than program expenses.

4. **Fundraising Effectiveness Ratio** = [fundraising expenses] / [contributions] & [fundraising revenue ratio]/100: This shows how much is being spent on fundraising in relation to contributions received and measures effectiveness of fundraising efforts; the 2nd figure represents how much it costs to raise $1.

5. **Liquidity Ratio** = ([net assets at end of year] - [fixed assets]) / ([total expenses]*12): This shows the number of months/years of expenses that can be covered by existing assets.