THEME: NON-PROFIT ORGANIZATIONS

By John W. Day, MBA

<u>ACCOUNTING TERMS: Fund; Asset; Fund Balance</u>

According to the "Financial and Accounting Guide for Not-For-Profit Organizations" written by CPAs Gross, Larkin, Bruttomesso, and McNalley, (fifth edition, pg 25) the definition of a these three terms is as follows:

- A *fund* is any part of an organization for which separate account records are kept.

- *Assets* are valuable things owned or controlled by the organization. Types of assets include cash, investments, property, and amounts owed to the organization.

- *Fund balance* is the mathematical number obtained by subtracting total liabilities from total assets; it is a numerical representation of the net worth of the organization, but has no other significance. Fund balances do not exist except on paper; unlike assets, they have no intrinsic value and cannot be spent. Both assets and fund balances (as well as liabilities, revenues, and expenses) are part of the accounting records of a fund.

<u>FEATURE ARTICLE: Non-Profit Organizations</u>

A few years ago, a dentist client of mine, who did a lot of work for low-income patients under the California medical assistance program called "MediCal", asked me a bizarre question. He wanted to know if he could be considered a "non-profit organization" since he did so much MediCal work. At first, I thought he was joking, but he was serious. I told him that just because he charged less for his services did not qualify him to become exempt from paying taxes. In fact, he made a very nice profit. However, this is a good example of how non-profit organizations (NPO's) are misunderstood by a large segment of the general public.

Most countries around the world have NPO's, but outside the U.S. they are called non-governmental organizations (NGOs) or civil society organizations. These organizations are exempt from paying taxes because they provide some sort of public benefit. They are said to enhance the fabric of society. They differ from a business organization in that there are no owners. A Board of Directors oversees operations of the organization. An Executive Director, who reports to the Board, functions like a CEO of a business. Usually there is a lengthy application process to establish the mission or purpose of the organization before exempt status is granted.

According to Independent Sector, an organization that serves as an information resource for non-profit boards, there are 1.5 million non-profits that, when combined, have general annual revenues totaling more than $670 billion dollars. They report that six percent of all organizations in the U.S. are non-profits and one in twelve Americans work for a non-profit. That's big business and has caused profit-making businesses to become alarmed that some of these NPOs are competing unfairly. Think about a private hospital as compared to a non-profit hospital. The profits of the private hospital are taxed, but the NPO hospital can apply all their profits to higher salaries, more equipment, etc. Hence, there is high scrutiny of NPOs by the Internal Revenue Service, state Attorney General offices, private watchdog organizations, and the press.

There are all types of non-profit organizations. Public charities are exempt under the Internal Revenue Service code 501(c)(3). These organizations, such as hospitals, museums, orchestras, private schools, churches, scientific research organizations, soup kitchens, etc., obviously do much more than provide free care and services to the needy. To qualify for exempt status, these organizations must show broad public support, rather than funding from an individual source. In addition, there are private foundations, colleges, universities, social welfare organizations, professional and trade organizations, and many more. Governmental organizations such as communities and agencies are also non-profit organizations, however, their accounting and record keeping is handled quite differently from 501(c)(3) organizations.

Briefly, the books of an NPO are organized in the same way as a profit-making business except for a few differences. It's okay for a non-profit to make a profit because there may be many uses the board has planned for the extra money. But, NPOs traditionally refer to profit as "Excess Revenues over Expenses" to avoid being mischaracterized as a profit-making organization. A net loss is called "Excess Expenses over Revenues". Recall the fundamental equation that makes double-entry accounting work:

ASSETS = LIABILITIES + EQUITY

Instead of the term EQUITY, a non-profit will substitute the words FUND BALANCE or more recently NET ASSETS. The concept is still the same. After subtracting liabilities from assets the difference is what is owned by the organization. Where NPOs differ in their financial statement presentation from profit-making businesses is what is called Fund Accounting. Obviously, the presentation varies depending on the purpose and size of the organization. For instance, a Little League baseball organization may only have one fund for which they have to account. They also may not have any restrictions placed on the usage of contributions they receive. Everything is straightforward. Or, a scientific research organization may be working on various projects at the same time with funding sources made up of private and governmental grants or contracts, private donations, sales of research documents, some of it restricted to specific expenditures and the rest unrestricted. The accounting challenge is to report the revenue and expenses accurately for each fund or project and be able to combine all the funds into one cohesive financial statement.

The problem in the past for the contributors was that they could not easily tell from the financial documents what funds were restricted and unrestricted and whether their contributions were being spent properly. The Financial Accounting Standards Board (FASB) decided that all external accounting should be done using the "Net Assets" approach as opposed to the "Fund Balance" approach. Essentially, the net assets approach requires that the equity of the organization be presented with three classes of assets, i.e., Restricted Assets; Temporarily Restricted Assets; Unrestricted Assets. You can still use Fund Accounting for internal bookkeeping purposes, but for external reporting purposes you are required to disclose your restricted and unrestricted funds. If you have no restricted funds, then it is not much of a challenge.

One of the key factors in setting up non-profit books is a well thought out Chart of Accounts. In other words, this is choosing which general ledger accounts are the most appropriate for recording revenue and expenses, etc., and organizing them in such a way as to provide meaning. Some U.S. organizations simply follow the same format found on the 990 IRS form for non-profits. They do this so that their financial statements are in conformity with the way that return is organized. This makes it easy to transfer information from their financial statement to the 990 form. Nevertheless, the main thing is to design your accounts so that they tell you exactly where your revenue came from and what expenses are related to that revenue. I have worked with NPOs that have not done a very good job of this in the beginning, and I can testify that it is no fun trying to straighten the accounts out later. It may be well worth the money to hire a competent accountant to guide you through the set up phase. Better yet, let your accountant review your books a couple of times a year just to make sure you are on track and save yourself some year-end grief.

QUESTION: What Is The Difference Between Fund Balance and Net Asset Accounting?

I have alluded to the difference in the feature article above, however, if you have never seen these approaches before, then it's pretty hard to know what I'm talking about. Therefore, here are some examples. Using the Fund Balance method, the equity section of your balance sheet might look like this:

Fund Balance Method:

Fund Balance for Project A	**$ 5,100**
Fund Balance for Project B	**3,700**
Fund Balance for Project C	**4,100**

Total fund Balance	**$ 12,950**

If you used the Net Assets Method it would look like this:

Net Assets Method:

Unrestricted Funds	**$ 5,450**
Temporarily Restricted Funds	**3,550**
Permanently Restricted Funds	**3,950**
Total Net Assets	**$12,950**

You can see that the difference between the two is the portrayal of restricted and unrestricted funds. The Net Assets approach requires more complexity in record keeping and unless you have special software, it may require manual calculations. For example, when using straight fund balance accounting you can set up each fund with its own revenue and expense statement.

	Fund A	**Fund B**	**Fund C**
Revenue	**$19,800**	**$7,650**	**$17,100**
Expense	**-16,700**	**-4,900**	**-13,500**
Excess Revenue	**3,100**	**2,750**	**3,600**
Beginning Fund Balance	**2,000**	**1,000**	**500**
Ending Fund Balance	**$5,100**	**$3,750**	**$4,100**

Notice how easily you can match the ending fund balance for each fund with those listed above in the example of the balance sheet. This is why small organizations prefer this method over the net assets method, because you will have create a separate report that regroups the information into restricted and unrestricted fund balances. Most inexpensive accounting software programs such as QuickBooks allow multiple cost centers, which is great for presenting various projects or funds as shown above. It becomes problematic when you have to create three columns of revenue and expenses on one page. For instance:

Project A	**Unrestricted**	**Temporarily Restricted**	**Permanently Restricted**
Project B	“	“	“

Project C “ “ “

If all your funds are unrestricted then there is no problem because only one column is needed. Also, if you only have one fund, then you can set up three cost centers for each of the above categories. The complexity arises when there is more than one fund to keep track of.

On the IRS form 990, for U.S. non-profits you will see a choice to report your net assets according to the FASB Statement of Financial Accounting Standards (SFAS) No. 117 or by fund balance. If you want your financial statements to be prepared according to Generally Accepted Accounting Principles (GAAP), then you must follow the SFAS 117 pronouncement.

TIP How To Record Revenue And Receivables When Using Cash-Basis Accounting.

If your organization is subject to a formal audit then you probably need to be using full accrual accounting. However, many small organizations use either a cash-basis accounting approach or what is called a modified cash-basis approach. The modified approach uses primarily a cash approach with some accruals, i.e., receivables and payables. A typical example is a small organization whose livelihood is based on grants. At the beginning of each year the grant or grants are awarded but the money is received later in the year. This could also be true for contracts that are awarded initially but the money is not received until a certain amount of work is finished. The organization wants to keep track of cash coming in and cash going out. They also want to keep track of grants, contracts or pledges that are still outstanding. The following is an easy way for you to keep track of this type of activity:

Let’s say that you were awarded a $50,000 grant. The day you received the formal document you should record the grant on the books using a general journal that looks like this on the modified cash basis:

DESCRIPTION	DEBIT	CREDIT
Grants Receivable	50,000.00	
Deferred Revenue		50,000.00

When you receive a portion of the grant money, say, $10,000 record it like this:

DESCRIPTION	DEBIT	CREDIT
Cash	10,000.00	
Grants Receivable		10,000.00

But, don't forget there is another step to take:

DESCRIPTION	DEBIT	CREDIT
Deferred Income	10,000.00	
Grant Revenue		10,000.00

Let's review what you have accomplished with these journal entries. First you recorded the full amount of the grant, but because you hadn't yet received any money you deferred the revenue. The Grants Receivable is an asset and the Deferred Revenue goes in the liability section of your balance sheet. Second, when cash was received you recorded the increase to cash and decreased the Grants Receivable because you now only have $40,000 remaining. Third, since you actually received $10,000 in cash you can report that as revenue under the category of Grants. You no longer have $50,000 of deferred revenue so you decreased it by $10,000 to accurately reflect $40,000, which is now the case.

This is not that complicated to understand and it is a handy tool that helps keep track of what is actually going on in the organization.

John W. Day, MBA is the author of two courses in accounting basics: Real Life Accounting for Non-Accountants (20-hr online) and The HEART of Accounting (4-hr PDF). Visit his website at http://www.reallifeaccounting.com to download his FREE e-book pertaining to small business accounting and his monthly newsletter on accounting issues. Ask John questions directly on his Accounting for Non-Accountants blog.

