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Financial Management For Nonprofits

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CORPORATION *for* SUPPORTIVE HOUSING

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Introduction

Today, more than one million nonprofits operate in the United States, employing millions of America's workers. Nonprofits range from community-based housing and service organizations to local theaters to large, powerful organizations such as Harvard University, Blue Shield, and the American Association of Retired Persons.

Nonprofit organizations are granted tax-exempt status to enable them to provide services in the public interest. In exchange for such privileges as exemption from federal and state income taxes and the ability to solicit tax-deductible contributions, these organizations are expected to perform their programmatic functions in an effective, efficient manner. Both internal and external readers of financial information want to see how effectively and efficiently resources are used to meet program goals.

Internally, sound financial information is used to:

- Engage in planning;
- Guide decision-making about programs;
- Identify areas for improvement in efficiency;
- Anticipate financial problems; and,
- Suggest strategies for financial stability.

Accurate financial management information provides information to enable the nonprofit manager to make better decisions faster.

Externally, sound financial management allows the organization to be accountable to:

- Funding sources, both private and public;
- Regulatory and tax authorities, such as Internal Revenue Service;
- Contributors;
- The organization's constituency; and,
- The general public

Financial information is generated from the accounting system. The financial manager uses that information to guide operations to make the best possible use of the organization's financial resources to achieve its goals.

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Financial Activities in Nonprofit Organizations

Financial activities can be grouped into three areas:

1. ***Planning & budgeting*** are those processes whereby the organization sets goals and objectives, allocates its resources among its activities and decides how those activities will be operated. Budgeting is a process that relies both on financial information about past performance and the organization's future plans. Concerns in this area include:

   - Involving people appropriately in the budgeting process;
   - Considering both internal and external factors in budget development;
   - Using past and current information to develop realistic projections; and,
   - Agreement on the use of the budget in managing the ongoing operations.

2. ***Transaction handling and record-keeping*** is the bookkeeping/accounting area of financial activities. Checks must be written to pay bills; incoming checks must be deposited, commitments of the organization and commitments to the organization must be recorded, an ongoing record of financial activities must be kept and the information must be presented to executives of the organization in an understandable and useful manner. Concerns in this area include:

   - Hiring appropriate and knowledgeable staff;
   - Timely and accurate recording of financial transactions;
   - Proper authorization of payments;
   - Prompt deposits of receipts; and
   - Timely and accurate preparation of financial reports.

3. ***Financial management*** is the management of current financial operations based on analysis of financial information and knowledge of the organization's objectives and plans. The financial manager oversees and directs the accounting process and participates in budget development and revision. In addition, the financial manager is responsible for such activities as cash flow management, cost allocation, cost analysis and asset management. Concerns for the financial manager include:

   - Anticipation of financial problems;
   - Maximizing use of financial resources;
   - Ensuring tax compliance;
   - Ensuring compliance with funder requirements;
   - Ensuring compliance with generally accepted accounting principles (GAAP) applicable to nonprofit organizations; and
   - Providing meaningful information to program managers.

Administration of the Fiscal Office

The administration of the fiscal office involves developing the staffing and the internal control systems to accomplish the above functions. Questions include:

- Should we hire a bookkeeper or an accountant?
- Should we compile our own financial reports or contract an outside CPA firm to compile them for us?
- Should the executive director do the overall financial management or do we need a finance director?
- What accounting software should we employ?
- Do we need an audit and, if so, how do we choose an auditor?

Such administrative systems are not financial functions by themselves, but are the kinds of management questions that the organization needs to address.

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Budgeting

For many nonprofit organizations, planning and financial management are activities that divide rather than unite the organization. Program planning is often viewed as the domain of the executive director, program directors and the board. Fiscal management is assigned to the bookkeeper, accounting and finance director and perhaps the board treasurer. Program planners and fiscal managers speak different languages and often have different priorities, and may or may not be aware of the importance of the other's approach to the budget process. Program planning decisions often are viewed as failing to reflect economic realities, while fiscal management decisions are often viewed as insensitive to the programmatic mission of the organization. These conflicts are often fought out during the budgeting process, the very process that should unite these viewpoints.

What is a Budget?

Budgets are tools of the financial management system used for two central management functions: decision making (planning) and monitoring and controlling. A budget is a plan of action expressed in financial terms. In the course of planning, an organization defines its purpose, mission, goals, objectives, strategies and activities. Through the budget process, decision-makers look at the financial implications of their plan: how much a program will cost and what are the anticipated revenues. Within the limits of scarce resources, priorities are set and budgets are created.

The budget is also a tool for monitoring and controlling ongoing organization activities. Once a plan has been developed, the organization needs information to see whether it is keeping to its plan. If the organization has gone "off track", various responses can be considered. Since the budget describes the plan in terms of dollars, it provides a basis for monitoring progress. If, for example, a program is costing more than anticipated, it may be necessary for management to bring costs down, or it may be decided to review the plan to take a higher level of expense into account.

A budget can be thought of as the organization's plan of action, expressed in dollars. A budget describes and estimates the expected income from different sources and the expenditures, needed to make to achieve its program objectives.

Since a budget is a planning document, effective budgets are those, which accurately anticipate and project the interplay between program and fiscal activity. This is one reason some organizations choose to include projected service statistics in the budget documents. An effective budget serves as a guideline, which reflects the best estimate by an organization's decision makers of the anticipated income and the costs of operating various program activities.

Budgets should not be documents, which are developed each year, only to be filed away until the next year. They should be useful tools, used to anticipate problems and to provide a baseline against which actual program and financial experience can be monitored.

Budgets should not be designed to "look good" to someone else, i.e., a funder, a board member, a director or the public. When budgets are designed to create an impression rather than an expression of program plans, they lose their ability to assist the organization in planning, monitoring and controlling.

In sum, an organization needs to prepare annual budgets because budgets assist organizations to:

- Define goals for a given period of time;
- Monitor progress throughout that period of time;
- Point out significant variances between the financial goals and how resources are actually being used;
- Take corrective action as problems arise;
- Predict and monitor cash flow; and,
- Illustrate need to funding sources.

Planning and Budgeting Process

The budgeting process is a complex one that can involve the entire organization, i.e., the executive director, financial staff, the finance committee and treasurer of the board, the board's fundraising committee, program staff, etc. Involving appropriate individuals in the process will provide opportunity to unite different viewpoints. Following is a ten-step approach to budgeting process:

Step 1: *Establish the budget period and review program achievements and financial performance for the current year.*

A budget period need not be from January 1 to December 31. The budget period should be the same as the organization's accounting (fiscal) year. This facilitates comparisons of budget projections to the actual financial experience of the organization.

Both staff and board should review program achievements and financial performance for the current period. This would include, but not be limited to reviewing objectives achieved, program statistics and cost per unit of service or outcome achieved, and comparing current year's budget to actual. In some situations, where budgeting process starts prior to the beginning of an accounting year, the current year's information might not be available for a whole year. In this situation, management should prepare a projection of actual income and expenses and other statistical data for the remainder of the current year for use in the budgeting process.

Step 2: *Identify major programs and activities of the organization and set goals and objectives for the budget period.*

The major programs and activities of the organization that are identified should be the same as those used by the accounting department in generating financial reports. The organization should develop (or review and revise) its long-range plan, and then develop a list of program and organizational objectives to be achieved during the year. By defining measurable objectives, the organization can later determine to what extent those objectives have been achieved.

Step 3: *Decide on method of cost assignment/allocation and estimate the cost of required resources, i.e., expenses.*

Any organization will have some direct cost that are identifiable to specific programs/activities and some costs that benefit two or more programs/activities (i.e., shared costs). The organization needs to decide about how these costs will be assigned, if direct or allocated, if shared, to different programs/activities, prior to putting a budget together.

Determine the number of staff, supplies, and other resources needed to attain objectives, based on your organization's past experience, the experiences of other agencies, and current considerations. Remember that in addition to resources directly used for a program, there may be hidden costs required to support a program. For example, if a new program will require ten new staff positions, plans must be made considering time to hire, train and support the new staff, as well as advertising costs, office equipment and furniture, etc.

In estimating the cost of required resources, the organization must not only determine the direct costs of running a program, but should determine the allocable portion of shared costs, such as rent, telephone, utilities, supplies, as well as an allocable portion of overhead costs, such as accounting, office management and administration, marketing and fundraising.

Step 4: *Estimate anticipated income.*

Just as expenses are planned, income must also be planned. Again, historical information, the experiences of others, and current considerations will form the basis for income estimates. It is difficult to project income when it comes in larger chunks from fewer sources, such as foundations, corporations and government agencies. After making the most realistic assessment possible, it is very useful to develop contingency budgets for more conservative or optimistic projections of income. As a rule of thumb, it is always best to err in the direction of a very conservative estimate of income when a source of income is unknown, highly competitive and not intended for ongoing support (i.e., foundations, corporation, etc.)

Step 5: *Bring income and expenses into desired relationship.*

Once the initial estimates for income and expense have been made, the organization can see whether it has a balanced budget or whether income or expense exceeds the other. An organization may choose to incur a deficit during a budget period, realize a surplus, or simply break even. There is no rule that budgets must balance in each budget period; however, large deficits can, of course, lead to bankruptcy and an end to the service being provided. Large surpluses may represent an abrogation of responsibility for serving the public interest. For any given period, however, the income and expense should be in the relationship the organization chooses, rather than mechanically balanced.

Organizations should keep in mind that the only way to stay a going-concern is by building up an operating reserve. This can only be achieved by raising unrestricted contributions and/or by ensuring that fee for services exceed the cost for providing such services. If a nonprofit organization breaks even or operates at a deficit year after year, it will eventually experience cash flow problems to an extent that expanding or sustaining services may become impossible. Organizations should strive to build an operating reserve of at least 3-6 months of operating expenses to cover the loss of a major grant or for start-up costs for a new program.

To bring income and expense into the desired relationship, programs need to be re-evaluated and adjustments made. In some cases, fundraising goals may need to be increased. When reviewing the income budget, it is important to avoid the temptation of raising the estimate without changing the plans for generating the additional income. It is not enough just to say "We'll try harder to raise money this year". An organization should have a carefully planned fundraising plan that is reviewed on a regular basis and monitored against its goals. If the fundraising plan turns out to have been unrealistic, budget modifications will need to be made.

If expenses need to be reduced, it is helpful to determine what each program/activity would cost at different levels of intensity. For example, one might find that the cost of providing services for Program A at one-half the current service level results in a decrease in costs by one-third. Don't assume that benefits and costs move together, with each additional dollar spent resulting in an additional dollar of benefit. "Economics of scale" are present in most projects, and beyond a certain point, additional expenses may bring a diminished return. As a result, there may be some programs where a large reduction in expenses will result in less reduction in services than in other programs.

Cost-benefit analysis is a tool that an organization may find helpful in making hard decisions regarding cutting or increasing costs. Cost-benefit analysis is used to examine the costs required to achieve a certain objective and requires assigning dollar values to the benefits/objectives achieved.

Step 6: *Plan for cash flow.*

In addition to planning for income and expenses to support the organization's program objectives, an organization should prepare a cash flow projection, by projecting cash flows through the budget period. For example, even if an organization has a balanced budget, it may not receive the income until the end of the budget period, while its expenses may be spread throughout the period. A cash flow projection will help foresee cash flow problems and plan for solutions.

Step 7: *Approve the budget.*

While the staff is responsible for developing the budget, the board, acting in its governing role, approves the budget.

Step 8*: Implement the plan and the budget.*

Staff has the responsibility for implementing the plan and budget. The executive director and program directors should agree on what line items program directors are responsible for monitoring and controlling.

Step 9: *Compare actual income and expenses to budget.*

Reports comparing actual income and expenses to budget should be produced in a timely manner (no later than 2-3 weeks after the close of the month) and distributed to those with budget control responsibility, such as the executive director, the finance committee and/or the treasurer. Program directors should receive financial reports for their program so they can monitor their costs and income.

Step 10: ***Update cash flows, revise plan and budget as appropriate.***

Cash flow projections should be updated at least monthly based on the actual balance of cash at the end of the last month and updated information on timing of receipts and disbursements.

A budget should be a guide to, not a substitute for decision-making. Therefore, budgets should be used as a tool for assisting managers in their decision-making process. Budgets should be revised to reflect material changes in current financial and program data. Each revised budget needs to be approved by the board of directors. A revised budget helps the organization anticipate where it will stand at the end of the year, setting the stage for the next budget period.

THE BUDGET PROCESS

Some budgeting activities ideally take place before the formal start of the budget process, others during it, and others after the budget has been adopted. A budget calendar should be established, with time frames for each activity, and assignment of responsibilities. This diagram of a budget cycle includes an example of how responsibilities may be designated.

Budget Presentation

Separate the budget into an operating budget and a capital budget. Separate the operating budget and capital budget (if applicable) by proper division, i.e., department, program, activity, grant, etc. Keep support for each element of each line item in the form of narrative, formulas, assumptions used to calculate numbers and contingency percentages. Present an overall budget in a matrix format, by natural classifications (i.e., salaries, payroll taxes, rent, utilities, etc.) as well as functional classifications (i.e., administration, fundraising, membership development and individual programs). The capital budget should be presented listing individual items that are planned to be purchased and/or improved and their estimated cost.

Functional classification of budgets gives more depth to the line item budget. Functional budgets are valuable as planning and monitoring tools since a program's costs and income can be evaluated separately and considered in prioritizing among programs. Of course, the accounting system of the organization must be able to provide income and expense statements for each function, similar to the budget format, otherwise monitoring and controlling a functional budget will become impossible.

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Cash-Flow Analysis

It is obvious that if an organization has more expenses than income, sooner or later it will find itself in trouble. It is less obvious, however, when an organization has more income than expenses and still finds itself in financial trouble. This can occur if the income and the expenses occur at different times, so that there is not enough cash to pay for the expenses as they become due and payable. Most nonprofit organizations are constantly fighting the cash flow management battle.

The term “cash flow” refers to the need to have cash come in at the right times so that it is available to flow out as needed. Cash flow can be projected, monitored and controlled. Cash flow projections are typically developed as part of the budget process, so that possible cash shortages or cash surpluses can be anticipated. As the year progresses, cash flow projections can and should be updated as new information becomes available. Cash flow projections may be done weekly or monthly, depending on how tight cash is in an organization. Based on cash flow projections, management may decide to postpone a project, borrow money, cut expenses, or increase income. There is no universal format for cash flow projections, so organizations should establish one that meets their needs.

Though in preparing a budget the focus is on how much revenue and support the organization will earn, how much expenses it will incur, and how much of the support it will receive will be restricted to specific purposes, in preparing the cash flow projection, the focus is on the timing of receipt and disbursement of cash, regardless of its origins and use. For example, assume as organization has a contract to provide services for a governmental agency during the month of January for a total cost of $30,000. In February, the organization prepares and submits an invoice to the agency for the previous month’s services, but it doesn’t receive payment on the invoice until March. In this situation, the operating budget will show $30,000 in expected income for the month of January, where the cash flow projection will show an expected receipt of $30,000 in the month of March.

As part of cash flow management, financial managers consider a variety of responses. A projected temporary cash shortage can be resolved by:

- Obtaining loans;
- Withdrawals on lines of credit;
- Speeding up collection of receivables;
- Requiring fees to be paid in advance;
- Changing the timing of planned fundraising events or campaigns;
- Financing the purchase of capital equipment;
- Liquidating investments;
- Working with funders for a more favorable payment schedule; and,
- Delaying payments to vendors.

A projected temporary cash surplus can be taken advantage of by:

- Short term investments;
- Changing the timing of planned fundraising events or campaigns;
- Paying back line of credit balances.
- Buying supplies on sale (in bulk) that won't be needed immediately.

Notice that these methods address the timing of cash inflows and outflows, as opposed to increasing income or decreasing expenses.

A sample cash flow projection is shown as Exhibit 3.

Financial Statements

The end product of an accounting process is a set of financial reports, called financial statements, summarizing all financial transactions of the organization and showing its assets, liabilities, net assets, revenue, public support and expenses. A set of financial statements typically includes:

- Statement of Financial Position
- Statement of Activities
- Statement of Functional Expenses
- Comparative Income and Expense Reports by Activity

Statement of Financial Position *(See Exhibit 4)* shows an organization's:

- **Assets** — What the organization has title to;
  1. **Current assets** — Those categories of assets that the management intends and has the authority to convert to cash, such as receivables and prepaid expenses.
  2. **Non-current assets** — Those categories of assets that have been acquired to be used in the organization's operations and the management has no intention to or is not authorized to covert to cash, such as fixed assets and cash restricted for long-term investments.
- **Liabilities** — What the organization owes to the outside parties;
  1. **Current liabilities** — Those liabilities that are due within the accounting year, such as accounts payable, accrued salaries, current portion of long-term debt, i.e., the principal due within the accounting year.
  2. **Long-term liabilities** — Those liabilities that are due during subsequent accounting years, such as portion of long-term debt due in subsequent years.
- **Unrestricted net assets** — The portion of the organization's net worth that management and the board have complete control over;
- **Temporarily restricted net assets** — The portion of the organization's net worth that is committed for restricted purposes; and

- **Permanently restricted net assets** — The portion of the net worth that according to donors wishes cannot be used for day-today operations. Income from such restricted funds can be used for general operating purposes or be further restricted on a temporary basis by the donor.

This information is presented as a snap shot, i.e., at a given point in time, normally the end of each calendar month.

Statement of Activities *(See Exhibit 5)* shows an organization's:

- **Sources of revenue and public support** by category (i.e., government contracts, fees for services, foundation and corporation grants, contributions, interest income, etc.);
- **Expenses** by functional classification (i.e., administration, fundraising, membership development, program A, program B, etc.);
- **Change in net assets** (i.e., difference between income and expense) by net asset classes (i.e., unrestricted, temporarily restricted & permanently restricted);
- **Net assets at the beginning of the accounting year** by net asset classes; and
- **Net assets as of the last date of report** by net asset classes.

The information on the statement of activities is presented for a period of time, typically beginning of the accounting year through the last day of the reporting period.

Statement of Functional Expenses *(See Exhibit 6)* shows an organization's expenses by natural classifications, i.e., rent, utilities, supplies, postage, etc. and functional classification, i.e., administration, fundraising, etc. This statement is typically in a matrix format where columns represent functional classifications and rows represent natural classifications.

The information on the statement of functional expenses is presented for a period of time, typically beginning of the accounting year through the last day of the reporting period.

Comparative Income and Expense Reports by Activity *(See Exhibits 7 and 8)* show income and expenses of each of the organization's activities, i.e., administration, fundraising, program A, program B, etc., with a comparison to the approved budget or a comparison to the same period last year.

The information on the comparative income and expense reports by activity is presented for a period of time, typically beginning of the accounting year through the last day of the reporting period.

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Financial Reporting

Functional Reporting of Expenses

Generally Accepted Accounting Principles (GAAP) requires nonprofit organizations to present information about their expenses by functional classifications in the statement of activities to indicate their accomplishments during the reporting period. All nonprofit organizations are involved in two types of activities:

1. **Program services** are those activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Those services are the major purpose for and the major output of the organization and often relate to several major programs. The number of functional reporting classifications for program services varies according to the nature of the services rendered. For some organizations, a single functional reporting classification may be adequate to portray what may, in effect, be a single, integrated program service that the organization provides. In most cases, however, several separate and identifiable services are provided, and in such cases expenses for program services should be reported by the type of service function or group of functions. For example, a large supportive housing organization may have programs for housing development, support services, advocacy and public education and others.

2. **Supporting services** are all other activities of a nonprofit organization, other than its program services. They include administration, fundraising and membership development activities.

    a. ***Administrative activities*** are those that are not identifiable with a single program, with fundraising, or with membership development activity but are indispensable to the conduct of those activities and to the organization's existence. They include oversight, business management, general record keeping, budgeting, financing, and soliciting revenue from exchange transactions, such as government contracts.

The cost of oversight and management usually includes the salaries and expenses of the governing board (if applicable), the chief executive, and the support staff. If such staff members spend portion of their time directly supervising program services or categories of other supporting services, however, their salaries and expenses should be allocated among those functions. The costs of disseminating information to inform the public of the organization's stewardship of contributed funds, announcements concerning appointments, and the annual report, among other costs, should similarly be classified as administrative expenses.

b. ***Fundraising activities*** involve inducing potential donors to contribute money, securities, services, materials, facilities, other assets, or time. They include publicizing and conducting fundraising campaigns, maintaining donor mailing lists, conducting special fundraising events, preparing the fundraising manuals, instructions, and other materials, and conducting other activities involved with **soliciting contributions** from individuals, foundations, governments, and other sources.

Some materials and activities of nonprofit organizations accomplish a program purpose and attempt to raise funds simultaneously. This is very common with many direct mail activities that educate the recipient as well as solicit support. The costs associated with these activities may be directly attributable to education, directly attributable to fundraising, or may be attributable to both. To the extent costs are separately incurred, they should be charged to their corresponding function. Cost attributable to multiple functions are referred to as "joint costs"

All costs of informational materials or activities that include fundraising appeal should be accounted for as fundraising expenses unless **all** the following criteria are met:

i. **Audience** — The audience criterion is not met if the audience includes prior donors, or is otherwise selected based on its ability or likelihood to contributed to the organization.

ii. **Content** — The activity should call for specific action by the recipient that will help accomplish the entity's mission. **The action should benefit the recipient**. Educating an audience about an organization's causes does not represent a call for specific action. Requests for contribution does not meet this test either. To be a call for specific action, the activity must address specific steps that the audience is encouraged to take, such as stop smoking and suggesting specific methods, instructions, references and resources that may be useful in doing so.

iii. **Purpose** — This is the most complex of the three criteria. In determining whether the purpose criteria is met, the following should be considered:

- The activity must include a purpose involving the accomplishment of a program or administration function;
- Method of compensating any party's performance, i.e., compensation that varies based on contributions raised for that joint activity;
- Comparison of the joint activity with other activities of the organization; and,
- The qualifications and duties of the persons performing the joint activities. For instance, employees who are not members of the fundraising department are more likely to perform program or administrative activities than are employees who otherwise devote substantial amount of time to fundraising.

If the activity meets all the above criteria, the cost of such activity can be allocated between fundraising and program. See "allocation of cost related to joint fundraising activities" for methods of allocation.

c. ***Membership development activities*** include soliciting for prospective members and membership dues, membership relations, and similar activities. If there are no significant benefits or duties connected with membership, however, the substance of membership development activities may, in fact, be fund raising, and the related costs should be reported as fundraising costs.

Types of Costs

In a multi-activity organization, costs can be benefiting only one activity (direct costs) or they can be benefiting two or more activities (shared costs).

1. **Direct costs** are those costs that directly relate to a single supporting or program activity. As described above, GAAP provides guidance to nonprofit organizations as to what is considered direct cost of administration, fundraising, membership development and program activities.

2. **Shared costs** are not easily identifiable with a specific program or supporting activity, but they are nonetheless necessary to the operation of these activities, i.e., if the activity can not share such cost with another activity, they will have to bear the cost alone, such as rent, utilities, supplies, telephone, maintenance, etc.

Allocation of Shared Costs

Allocation of shared costs is a process by which costs can be fairly charged to all activities benefiting from those costs, whether they are program or supporting activities. To allocate shared costs two methods of allocation may be used, as follows:

1. **Case-by-Case Method** — Under this method each expense is allocated to program and supporting activities benefiting from them individually based on rate of actual usage or management's best guesstimate of benefits received by each activity from such expense. For example, typically, rent and related occupancy costs are allocated according to the square feet of space used by each activity, telephone expense is allocated according to number of telephones available to each activity or an actual usage log, supplies is allocated base on number of employees, etc.

   An advantage of this method is that it seems to make sense. A major disadvantage, though, is that it often requires a great deal of time-consuming record keeping. In addition, although the case-by-case method of allocation seems rational, arbitrary selection of the measure often lies behind the allocations. If, for example, the rent is allocated by square feet, how should we allocate the hallways, restrooms, or other common spaces?

EXAMPLE OF CASE-BY-CASE ALLOCATION METHOD

	Program	Admin.	Fundraising	TOTAL
Salaries	253,757	36,036	30,207	320,000
Rent	14,377	3,018	2,605	20,000
Telephone	7,189	1,509	1,302	10,000
Printing	10,438	6,302	10,260	27,000
Travel	9,000	15,000	9,000	33,000
Total	**294,761**	**61,865**	**53,374**	**410,000**

In the above example, since shared costs have been allocated using a case-by-case method of allocation, they are not easily identifiable.

2. **Allocation Rate Method** — Using this method one determines a rate by which shared costs, in a group, should be proportionately allocated to the various programs and supporting activities benefiting from them. Allocation rates are based on the principle, for example, if a program incurs one-third of all direct costs of the organization, it should bear one-third of the shared cost as well.

EXAMPLE OF ALLOCATION RATE METHOD

	Program	Admin.	Fundraising	Shared	TOTAL
Salaries	225,000	30,000	25,000	40,000	320,000
Rent	0	0	0	20,000	20,000
Telephone	0	0	0	10,000	10,000
Printing	9,000	6,000	10,000	2,000	27,000
Travel	9,000	15,000	9,000	0	33,000
Subtotal	***243,000***	***51,000***	***44,000***	***72,000***	***410,000***
Shared Costs	***51,761***	***10,865***	***9,374***	***(72,000)***	***0***
Total	**294,761**	**61,865**	**53,374**	**0**	**410,000**

In the above example, the ratio of direct cost of each activity to the total direct cost of all activities has been used to allocate shared costs. For example, since program activities are 71.9% of the total direct costs of the organization (243,000/338,000 (243,000 + 51,000 + 4,000) = 71.9%), they should bear 71.9% of the shared costs (71.9% x 72,000 = 51,761). Similarly, since administration incurs 15.1% of the total direct costs of the organization, it should bear 15.1% of the total shared costs.

There are many advantages to this method of allocation such as:

a. Reduction of cumbersome and time-consuming bookkeeping entries;

b. Accommodating easy budgeting of expenses; and,

c. Clarification of who is responsible for which cost, i.e., financial statements can be used to evaluate budgetary performance of directors.

Some organizations may have more than one shared cost pool, while others might use a combination of the two methods. For example, if an organization is located in two different geographical locations, it may have three shared costs pools:

1. Cost related to location A, which benefit activities operated out of location A;
2. Cost related to location B, which benefit activities operated out of location B; and,
3. Cost related to overall organization, which benefit all activities, regardless of location.

In another situation, organizations might use combination of the two methods. For example, they may use case-by-case allocation for costs that are shared between some (not all) activities, and use allocation rate method for costs that benefit all activities of the nonprofit organization.

There is no right method of shared cost allocation that is appropriate or best for all organizations. Each method results in different financial reports and may influence staff and outsiders differently. It is important to consider carefully all factors in order to make an informed decision on the allocation of shared costs and select a method that is appropriate and reasonable for the organization and apply such method consistently to all activities of the organization.

Same principles may be used to allocate costs related to one program among its various funders, when more than one funder funds the program. Many nonprofit organizations believe that they can charge an expense to a funder, simply because it is in the budget, or that expenses that are not in the budget should not be charged to an activity funded by an outside party.

Funders of nonprofit organizations change from year to year. What remains constant are the mission, purpose and activities of the organization. An accounting system should reflect what the organization does not who funds the organization's activities. When a funder refuses to pay for an expense, it does not mean that the expense did not incur for that specific program, or that it should be charged to another program, all it means is that management has to find other funding sources for such disallowed expenses.

Allocation of Cost Related to Joint Fundraising Activities

There is no particular method for allocating costs to joint activities that involve fundraising appeals. As long as a method is rational and systematic and results in reasonable allocation of costs it may be used. Different methods may be used for each joint activity, if appropriate. However, once an allocation method is adopted for a particular activity, it should be followed consistently. The two methods commonly used are:

1. **Physical Units Method** — Allocation is based on the number of units of output. Examples are lines of print, square inches, and physical content measures.

2. **Relative Direct Cost Method** — Allocation is based on each component's direct cost.

Indirect Costs

Contrary to popular belief, shared costs are not the same as indirect costs. Indirect costs, as defined by OMB (Office of Management and Budget) Circular A-122, is the combination of shared cost and administration cost of a nonprofit organization. The indirect cost rate, under the simplified method, is calculated as follows:

$$\text{Indirect cost rate} = \frac{\text{Total indirect cost}}{\text{Total direct cost}}$$

Therefore, the indirect cost rate for the above example can be calculated in the following two ways, depending on the method of cost allocation:

1. Using the case-by-case method of shared cost allocation:

$$\text{Indirect cost rate} = \frac{\text{Administrative cost}}{\text{Total other cost}} = \frac{61{,}865}{294{,}761 + 53{,}374} = 17.85\%$$

2. Using the allocation rate method of shared cost allocation:

$$\text{Indirect cost rate} = \frac{\text{Admin. + shared costs}}{\text{Total direct cost}} = \frac{51{,}000 + 72{,}000}{410{,}000 - 72{,}000} = 36.4\%$$

As you can see, depending on type of allocation method used, the indirect cost rate changes significantly. However, the dollar amount that you can recover from your government contracts will remain the same, regardless of the rate, since the rate is applied to a different base.

Overhead Costs

Overhead costs are total cost of supporting services in an organization, i.e., combination of administration, fundraising and membership development. This is an extremely important rate for funders since it indicates what percentage of funds contributed are used for program activities and what percentage is used for supporting activities. Of course, funders expect this to be as low as possible (somewhere around 25% to 30%).

Overhead costs and rate in the example above are calculated as follows:

Overhead costs = administration costs + fund raising costs = 61,865+53,374 = 115,239

Overhead costs = Administration costs + Fund raising costs = 61,865 + 53,374 = 115,239

$$\textbf{Overhead rate} = \frac{\textbf{Overhead costs}}{\textbf{Total cost}} = \frac{\textbf{115,239}}{\textbf{410,000}} = \textbf{28\%}$$

Project Cost-Benefit Analysis

Most nonprofit organizations tend to prepare a project budget to satisfy the grantor's requirements or limitations rather than looking at the true cost of a project. For example, if a grantor specifies that it will not pay for building operations costs, the nonprofit organization prepares a project budget without the building operations expense line items, or if the grantor limits reimbursement of such cost to $500 per month, the nonprofit organization shows $500 per month for building operations line items irregardless of the fact the reasonable allocation of building operations expenses to this project should actually be $400 or $3,000 per month. This approach results in not only misguiding the grantor, but also misguiding the management and the board of directors of the organization as to the real cost of a project.

No project is an island. An organization has to exist to run a housing program. The organization should be able to provide the cash flow required by the program, enough resources to support the program, and resources to fund building operations. A nonprofit organization should factor the following types of cost to arrive at a project cost:

- **Direct costs** of a project are those that are directly identifiable with the project and that they will not incur if the project is not undertaken by the organization. Examples include salaries of staff members working on the project, related travel, benefits, etc.
- Allocable portion of **shared costs,** i.e., those costs that indirectly benefit the project, but the project cannot exist without them. Examples include an allocable portion of rent, utilities, supplies, telephone, copier related cost, building repair and maintenance, insurance and similar type costs.
- A fair share of **overhead costs,** i.e., administration and fundraising expenses. Although the project can operate without the benefit of these costs for a short period of time, it cannot continue to operate successfully. For example, if there is no one to financially manage the project, employees and vendors won't get paid, the project will loose its staff and vendors and would have to shut down. Although most grantors are not willing to fund supporting services, a good number of them understand the necessity of supporting services and are willing to fund a fair share of such costs as a part of the project cost.

Cost-benefit analysis is the process of looking at expenses related to a project (realistically, not just to satisfy the grantor's requirements), comparing the cost to the income that can be derived from the project, and evaluating how the deficit of the project can be subsidized or the surplus of the project can be used to subsidize other program and/or supporting services. This process can be successful only if both the expenses and the income projections are realistic and not far-fetched goals.

Cash vs. Accrual Basis of Accounting

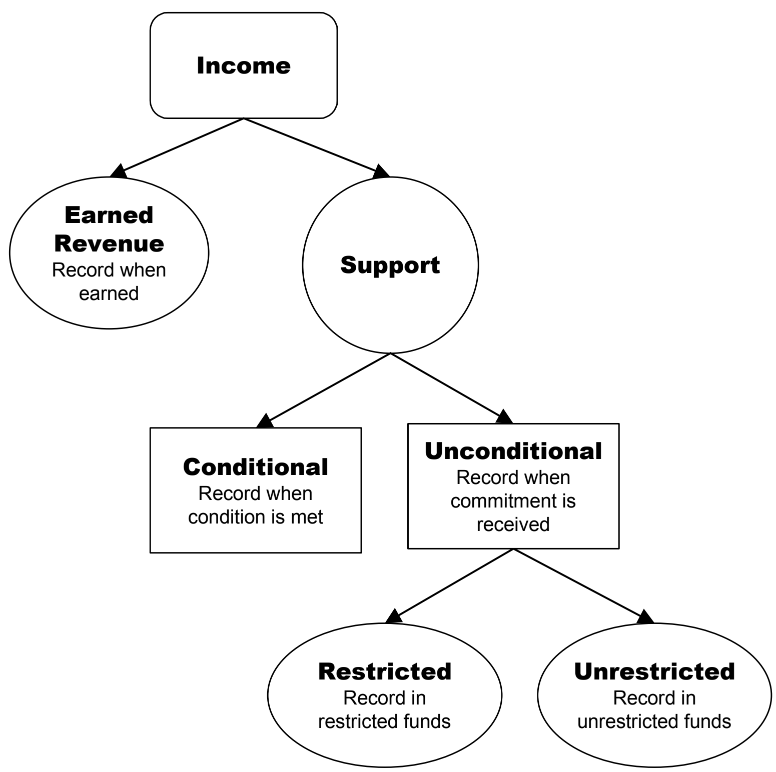
Cash basis and accrual basis of accounting are two different methods of recording income and expenses. They differ in the determination of when to recognize and record income and expenses in the financial records.

- **Cash basis of accounting** — Income is recorded when received and deposited and expenses are recorded when they are paid.
- **Accrual basis of accounting** — Income is recorded when earned and expenses are recorded when incurred.

Nonprofit organizations have to follow one additional rule (FAS 116) since their income consists of earned revenue and contributed income (grants and contributions). Whereas there is an earning process for earned revenue (for example provision of counseling services coincides with earning of the revenue), there is no earning process for support, since there is no quid-pro-quo exchange.

According to generally accepted accounting principles support may be conditional or unconditional**. Conditions are different from restrictions**. When support is conditional, the condition has to be met by the nonprofit organization; otherwise the donor can withdraw his/her commitment to the organization. When support is restricted, the nonprofit organization by accepting the contribution has a fiduciary duty to abide by the wishes of the donor and spend the funds to satisfy the restriction purpose and/or time. In other words, conditions determine when the income belong to the organization and therefore may be recorded, whereas restrictions determine how the funds should be recorded. Majority of government grants/contracts are exchange transactions and fall under earned revenue rules.

Conditional support can only be recorded as income when the condition is substantially met by the nonprofit organization. For example, if the condition is matching the funds, the organization can record the grant income once the matching funds are raised. Unconditional support should be recorded as income when the commitment (legally enforceable) is received by the nonprofit organization.



Accounting for Restricted Support

Nonprofit organizations may receive support that is:

- Unrestricted;
- Temporarily restricted; or
- Permanently restricted.

Since support is a nonreciprocal transaction, i.e., the contributor receives no direct benefit, as the result of his/her payment; any restriction on it must expressly come from the donor. Thus, if donor sends a contribution to a nonprofit organization and the board of directors decides to put the contribution away for a specific use, the contribution is considered unrestricted in accordance with generally accepted accounting principles.

The restriction can be in writing or verbal. A contribution is considered restricted if it is received as the result of solicitation of gifts by nonprofit organization for a specific purpose and/or time period, although the organization might not receive any written or verbal instruction from the donor. Contributions that are received on installments have implied time restrictions from the donor. For example if a foundation commits to a $50,000 grant for general operating purposes and pays the funds in four equal quarterly payments, the implied time restriction is that the nonprofit organization should only spend $12,500 per quarter.

Restriction on a contribution can be temporary or permanent. In temporary situations (ten year can be considered temporary), once the purpose restriction is met and/or time restriction has expired, the restriction is lifted and no further record keeping is required by the donor or grantor. On the other hand if the restriction of funds is permanent, the nonprofit organization cannot spend the principal of such funds, only the income may be spent (i.e., endowments). The donor can temporarily restrict the income or place no further restriction on the income. Since the principal of the contribution cannot be used for operations, continuous record keeping is required, and fund accounting should be used.

As mentioned before, Unconditional restricted grants and contributions should be recorded as income when the commitment is received. However, they should be recorded in temporarily restricted fund until such time that the purpose restriction is met or the time restriction has expired, at which point, they are recorded as a reduction of income in the temporarily restricted fund and an addition to income in the unrestricted fund as demonstrated in the following example:

	Unrestricted	Temp. Restricted	TOTAL
Contributions	5,000	10,000	15,000
Foundation grants	87,500	80,000	167,500
Net assets released:			
Purpose accmplished	30,000	(30,000)	0
Time expired	10,000	(10,000)	0
Total Support	***132,500***	***50,000***	***182,500***
Unspent balance, i.e.., increase in temporarily restricted net assets:		50,000	
Unspent balance of restriced grants: from prior years		5,000	
Temporarily restricted net assets		**55,000**	

Since restrictions on grants are not necessarily met within the same accounting year, the generally accepted accounting principles require nonprofit organizations to report their net assets (i.e., accumulation of their annual surplus (deficit) from their inception, or difference between their assets and liabilities) in the following categories to track the unspent balance of such grants, as well as the unspent balance of unrestricted funds:

- **Unrestricted** — The portion of the organization's net worth that is in complete control of the organization's management and the board of directors. In another words the board and the management can decide how to spend it or to further accumulate it.
- **Temporarily restricted net assets** - The portion of the organization's net worth that has been committed for specific projects and/or specific periods of time.
- **Permanently restricted net assets** — The portion of the organization's net worth that has been committed permanently, i.e., management and the board cannot opt to spend the principal and/or to add to the principal. The only way to lift such restrictions is by contacting the original donor(s) and or by court action.

Capitalization and Depreciation

Some items purchased by an organization have a life of over one year. These items, such as furniture and equipment, should be capitalized, i.e., recorded as an asset rather than an expense, and they should be depreciated over their useful life. Depreciation is the process of systematically breaking down the cost of an asset over its life and recording it as an expense in the periods in which the organization receives benefit from their use.

Once an item is capitalized, it should be recorded as a part of a fixed assets inventory. The inventory should be kept separate from the general ledger, and should include information such as the date of acquisition, description of the item, the cost, the method of depreciation, and the useful life. The fixed asset inventory should be updated as items are depreciated, sold, disposed of, or worn out.

In order to eliminate individual judgment as to which item should be capitalized and how they should be depreciated, the organization should adopt capitalization and depreciation policies. The capitalization policy typically describes items that should be recorded as assets and sets a dollar threshold for new items purchased. The depreciation policy describes the method by which the cost of an item will be distributed over the item's useful life and sets useful life of each class of fixed asset, i.e., computer equipment, furniture, leasehold improvements, other equipment, etc.

Whereas for profit organizations are bound by Internal Revenue Service regulations as to the method of depreciation and useful life of asset categories, nonprofit organizations are free to use any method of depreciation and set their own useful lives and asset categories. The simplest method of depreciation is called straight-line method. Under this method, the cost of asset is distributed evenly over its useful life. For example, if cost of a computer is $2,000 and the computer's useful life is five years:

$$\text{Annual depreciation expense} = \frac{2{,}000}{5} = 400$$

In-Kind Contributions

A nonprofit organization may receive donated materials or services. Donated materials should be recorded at their fair value at the time of receipt. Donated furniture and equipment that fall within the organization's capitalization threshold should be capitalized at their fair value and depreciated the same way as furniture and equipment that are purchased by the organization. The fair value of donated material is not necessarily equal to the amount that the donor will claim on his/her tax return. Nonprofit organizations are not responsible to give donors a value for their gifts and should only describe the donated gift when acknowledging the gift.

Donated services can only be recorded at their fair value if:

- They create or enhance a non-financial asset (for example, repairs to a building, packaging inventory, etc.), or
- They require specialized skills, are provided by an individual possessing those skills, and would typically need to be purchased if not provided by donation.

The fair value of donated service is equal to the customary rate charged in the profession.

Fund Accounting

Fund accounting is a process by which resources for various purposes are classified for accounting and reporting purposes into different funds established according to their nature and purpose. Separate accounts, i.e., assets, liabilities, net assets, income and expenses, are maintained for each fund and tracked separate from other funds.

Not all nonprofit organizations use fund accounting. Most small nonprofit organizations use cost center and/or profit center accounting, i.e., only income and expenses related to their different activities are tracked individually.

Fund accounting typically is used when an organization has to track more than its operating fund, i.e., an endowment fund or a capital campaign fund.

Financial Management

Financial management is the management of current financial operations, based on the analysis of financial information and knowledge of the organization's objectives and plans. The financial manager, who is not always an accountant, oversees and directs the accounting process and participates in developing and revising budgets. In addition, the financial manager is responsible for such activities as cash flow management, cost allocation, cost analysis and asset management. The financial manager should:

- Anticipate financial problems;
- Maximize the use of financial resources;
- Ensure tax compliance and compliance with funder requirements;
- Provide meaningful information to program managers; and,
- Develop, implement, monitor and revise a system of internal controls.

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Financial Analysis

Financial statements should enable readers to evaluate the organization's financial performance. Financial analysis is the process of using the information provided by the financial statements to calculate the financial ratios and other measures that enable such judgment. To be meaningful, these ratios and measures should be compared to those established for the industry, those of similar type and size nonprofit organizations, or those of the same nonprofit organization for different periods. These comparisons, however, do not in themselves answer any questions, but they help readers to understand the current status of the organization, the likely causes of its status, and the appropriate tactics that will sustain or improve future performance.

Measures of the Consistency between Financial Resources and Activities

Organizations may have excessively high or modest ambitions. Some measures assess the range of the possibilities available to a nonprofit organization. A wealthy organization can contemplate a range of activities, while one with less wealth may have fewer options. Organizational wealth can be measured with a number of ratios. Liquidity and long-term solvency are the two most commonly used.

Liquidity ratios measure the organization's ability to meet its needs for cash in the short term. Some liquidity ratios commonly used are:

Current ratio = Current assets/Current liabilities

This ratio measures the organization's ability to pay for current obligations or liabilities as they become due and should always be greater than one.

Working capital = Current assets — Current liabilities

This measure shows the capital needed to carry out the day-to-day work and should always be positive.

Long-term solvency measures the organization's reliance on debt in its capital structure and its ability to repay the debt and the related interest charges as they become due over the long-term. Some long-term solvency ratios commonly used are:

- **Leverage ratios** - The term highly leveraged means a high proportion of debt relative to the level of equity. Several ratios are used to measure leverage, such as:

  Debt to Asset = Total Liabilities/Total Assets

  Debt to Equity = Total Liabilities/Net Assets

  These ratios measure the relative mix of internally and externally provided capital.

- **Coverage ratios** — The ability of an organization to generate sufficient cash to meet its commitment for future payments is measured by coverage ratios. These ratios include:

  Time Interest Earned Ratio =
  (Cash flow from operations + Interest expense)/Interest expense

  Time Fixed Charges Ratio =
  (Cash flow from operations + Interest expense + All fixed charges)/
  (Interest + Lease payments + Other fixed expenses)

  These ratios measure the ability of the organization's cash flow to meet its fixed payment and interest expense commitments. Principal payments are often included in the denominator as well.

Measures of Intergenerational Equity

An organization that does not have sufficient income for maintenance of the purchasing power of its net assets is using past savings to finance the present. Conversely, an organization whose net assets increase by more than the rate of inflation is using the present to finance the future. Another way to think about this concept is in personal terms. If you do not add enough money to your savings to maintain its purchasing power, you are depleting your past savings to maintain your present activities. Conversely, if your savings increase by more than the rate of inflation, you are consuming less than you currently have available, in order to benefit the future. You may have precisely one of these goals in mind. So one is not necessarily better or worse than the other. This can easily be measured by the following calculation:

Return on Net Assets = Surplus (Deficit)/Net Assets

If the ratio is larger than the rate of inflation, the organization is saving some of the results of the present to finance the future. Thus, a ratio different from the rate of inflation indicates the presence of intergenerational transfers.

Measures of the Match Between Sources and Uses of Funds

Answering this question requires classifying all income and expenses, assets and liabilities as either long-term or short-term and then examining the relationship between them. Long-term fixed expenses should be matched with long-term stable income. If the ratio of long-term stable income to long-term fixed expenses is less than one, the organization is in some financial jeopardy, in the long-term, because its expenses may not be covered by its income. Similarly long-term assets should be financed with long-term sources of capital, such as unrestricted net assets and long-term debt, rather than with short-term borrowing or short-lived income.

Variability and controllability indicates whether resources are short or long-term. A grant received for only one time, for example, is highly variable and may be uncontrollable. It is therefore a short-term resource. Endowment income is controlled by the organization but it may be highly variable, depending on the investment strategy. If endowment income varies considerably from one period to the next because of the investment strategy chosen, it should be considered as a short-term income source. On the other hand, if endowment income over time has proven to be very stable, it should be classified as a long-term income source.

Measures of the Sustainability of Financial Performance

The warning not to put all your eggs in one basket finds its financial equivalent in measures of the dispersion of the sources. These measures are key to evaluating sustainability. Dispersion simply measures the fraction of the total category accounted for by one activity in that category. The higher the concentration, the lower the dispersion. For example, an organization whose endowment income accounts for eighty percent of all its income has a high concentration of income. But an organization with ten sources of income, each of which accounts for ten percent of its total income, is on a more stable footing, i.e., its dispersion is low.

Red Flags in Financial Analysis

A substantial change in the size of some ratios, either in relationship to past performance or in relationship to other organizations similar in purpose, often indicates serious financial troubles. Presented below are some of these red flags:

- **Reduction in administrative or programmatic expenses** — In the short run, discretionary supporting expenses such as accounting or fundraising that support the organization's primary functions can be reduced without causing immediate negative repercussions. But in the long run, continued deferral or reduction of such expenses will inevitably cause serious negative consequences.
- **Increase in short-term liabilities** — "Sitting on the payables" is an instinctive reaction. An organization short of cash does not pay its bills. Some may even send checks they know will bounce, hoping for just one more delivery of supplies. Inevitably, these strategies only hamper the organization's ability to obtain the services and supplies it needs.
- **Continuing declines in difference between income and expenses** — This generally indicates that an organization is unable either to plan properly or to implement its plan effectively. If these conditions persist, it will have to shrink its size to continue operating. Losses or declines in the surplus are usually a signal of problems unless the surplus was previously very high, or the reduction was caused by carefully planned increases in program or supporting service expenses.
- **Increase in receivables and inventory turnover** — This may indicate a sloppy or distracted management. Excessively slow turnover of these assets means that resources that could be used to provide services are tied up in inventories and receivables. While seldom a signal of immediate severe distress, if inventories or receivables are material, slowdowns in turnover may signal management inefficiency that should be corrected.
- **Continued negative unrestricted net assets with positive restricted net assets** — This normally indicates that organization is using its restricted resources (i.e., for future periods and/or purposes) to pay for its current bills. While this can be sustained for a short while, eventually it will cause severe cash flow problems and will hamper the organization's ability to pay for services and supplies.

Internal Controls

Nonprofits, like all organizations, are vulnerable to deliberate theft and misguided use of funds for unauthorized purposes. The same idealism and commitment that bring talented and committed people to the nonprofit section may however, also make them reluctant to impose controls on trusted staff. Internal control procedures are designed to improve the quality of information and reduce the possibility of error, fraud, and mismanagement.

Purpose of internal controls is to:

- **To ensure the reliability of financial records**. Managers depend on accurate financial information to make programmatic and financial decisions. Program planning is influenced by the financial performance of the program and demonstrated in the financial statements;
- **To safeguard the organization's assets**. Money and the physical assets of an organization can be stolen, misused, or accidentally destroyed unless they are protected by adequate controls;
- **To promote operational efficiency**. Controls within an organization reduce unnecessary duplication of effort and guard against misallocation of resources; and,
- **To encourage adherence to management policies and funder requirements**. Management establishes certain procedures and rules to encourage the pursuit of the organization's goals and funder requirements. Proper controls ensure that staff adheres to such policies.

The elements of an effective internal control system include:

- **Segregation of duties** — Responsibilities should be divided among different employees to reduce opportunity for committing fraud or unintentional errors.
- **Board and staff accountability** — Clear definitions of responsibility and clear lines of authority.
- **Record keeping and information systems** — Maintenance of accurate financial and program data, with appropriate supporting documentation and authorizations.
- **Audit trail** — A means by which a transaction can be followed from either end, i.e., from the original source document to the final record or from the final record to the original source document.

- **Policies and procedures** — Written operating policies and procedures such as personnel policies, and accounting policies and procedures. These policies and procedures should be updated at least annually.
- **Evaluation mechanisms** — The internal controls system should be evaluated and updated periodically to be effective.

Depending on the size, number, and nature of transactions in a nonprofit organization, controls may be variously distributed. In a small organization, some overlap of duties will be necessary. A key principle is the "segregation of duties", i.e., one staff person should not handle a financial transaction from beginning to end.

A minimal set of controls might include the following:

1. An Accounting Procedures Manual (APM) that describes the administrative tasks of the organization and who is responsible for each. The APM does not need to be a formal document, but rather a simple description of how functions such as check issuance or transfers are authorized and handled. Writing or revising the APM is a good opportunity to see whether adequate controls are in place;

2. In many cases, two signatures should be required on checks. In all-volunteer organizations, such as a small service clubs or fundraising groups, this policy discourages embezzlement and encourages and atmosphere of accountability;

3. Special attention should be paid to cash receipts, such as special event ticket sales. The same person should not receive the cash and do the recording of the income. Preferably pre-numbered tickets should be used and ticket issued and sold should be accounted for;

4. The board of directors should approve the annual budget, and the board or the board's finance committee should regularly review the financial statements and compare actual results against the approved budget;

5. Someone other than the bookkeeper should review the bank statements and canceled checks. As a part of this task, attention should be given to alternations, unauthorized signatures, endorsements and questionable checks to unknown vendors and/or employees; and,

6. The board should approve all leases, loan agreements, affiliations, grant proposals, and other major commitments of the organization. Normally, such approval would precede and accompany such documents.

The board should approve personnel policies that clearly define salary levels, vacation time, overtime, compensatory time, benefits, grievance procedures, severance pay, evaluations, and other personnel matters. The section on “Staffing Patterns: Who Does What” gives examples of how responsibilities may be divided in volunteer organizations and in small, mid-sized, and larger organizations.

A system of internal controls also should provide an audit trail for monitoring staff adherence to the prescribed policies and procedures. An audit trail means that a transaction can be followed from one end of the accounting system to the other, i.e., from the original ordering of items to final recording in the accounting system, or visa versa.

Internal controls do not, of course, guarantee that funds will not be taken or misused. Like a locked door, internal controls keep honest people honest.

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Staffing Patterns: Who Does What?

Each organization has a different mix of resources and each organization will assign responsibilities differently. See Exhibit 2: Staffing Patterns for some common models of staffing patterns that can serve as suggestions, rather than as prescriptions for a real situation.

Some organizations choose to have transactions handled by staff, but the bookkeeping and accounting done by an outside accountant on contract. Larger organizations more typically keep financial functions on staff, while others work with contract accounting services.

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Audits

Financial reports are used by people within the organization (staff and board) and by people outside the organization (IRS, funders, regulators, contributors, and stakeholders). Accounting standards, which are used by all organizations in external reporting, share a common language to ensure understanding and to make it possible to compare the finances of one organization to those of another. Organizations may choose more informal or unique reports for internal use, but must issue standard reports for external use.

When is an Audit Needed?

The federal government requires independent audits only for organizations that have expended more than $300,000 in federal funds within the year, (whether the funds were received directly or indirectly from the federal government). While some states require audits for all nonprofit organizations, most do not.

Government agencies may require an audit in accordance with:

- Generally Accepted Auditing Standard (GAAS);
- Generally Accepted Government Auditing Standards (GAGAS); or
- OMB Circular A-133 (A-133 audit).

Private funding sources, such as foundations also may require an audit, a review or a compilation of financial statements, depending on the level of their support.

An independent Certified Public Accountant (CPA) with current license issued by the State in which the CPA practices should perform the above services and report on his/her engagement. The difference in types of reports issued by a CPA (i.e., audit report, review report, compilation report) reflects different levels of assurance from the CPA regarding the accuracy of the information.

- In a **compilation** engagement, the CPA obtains financial data from the organization and organizes it into standard financial reporting formats. The CPA does not review the numbers for accuracy, nor state an opinion regarding the accuracy of the information.
- In a **review** engagement, the CPA performs a limited examination of the financial information prepared by the organization. A review offers limited assurance that the organization's true financial picture does not significantly vary from the information presented.

- An **audit** engagement is the most extensive examination of an organization's financial records. An audit may be described as a series of selective tests that give the CPA a basis for judging whether financial records can be relied upon. For example, auditors vouch a selected number of information presented to them by the management through confirmation with third parties, analytical reviews and/or review of invoices, purchase orders, grant letters, canceled checks, etc. The CPA decides on the number of samples based on her/his understanding of the internal controls policies and procedures. The basic audit process is the same for all three types of audits, i.e., GAAS, GAGAS and A-133 audits, following are the summary of differences:

  1. In a GAAS audit, the CPA only reports on fairness of financial information taken as a whole. The CPA does not have to report on his/her understanding of systems of internal controls, nor he/she has to test such controls.

  2. In a GAGAS audit, the CPA reports on fairness of financial information taken as a whole, as well as his/her consideration of the systems of internal controls and the organization's compliance with laws and regulations. However, the CPA is not required to test the controls.

  3. In an A-133 audit, the CPA reports on fairness of financial information taken as a whole, his/her consideration of the systems of internal controls, organization's compliance with laws and regulations, her/his consideration of the systems of internal controls related to federal grants and the organization's compliance with laws and regulations related to such grants. The CPA is required to test the internal controls related to the federal grants. For example, if the Executive Director should approve all expenses, the CPA will select a sample of expenses and look for the evidence of the Executive Director's approval.

  CPAs can issue different types of formal opinions. Most often, audit reports are unqualified. In these cases, the letter accompanying the financial statements includes wording such as, "*In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of XYZ Agency at December 31, 20xx, in conformity with generally accepted accounting principles*".

  A qualified opinion is issued when the CPA believes the financial statements are, in a limited way, not in accordance with generally accepted accounting principles, or the CPA is unable to perform sufficient testing in one or more areas (limited scope). A qualified opinion might include wording such as, "*In our opinion, except for the omission of the value of donated assets, the accompanying financial statements present fairly…*"

The CPA may issue a disclaimer of opinion if the insufficiency of evidence is to the extent where the CPA is unable to issue an opinion of the financial statements.

It is important to remember that an audit opinion does not address the question of the organization's financial health or long-term stability. Such assessments are left to the reader of the financial statements.

Selecting and Engaging an Auditor

Just as individuals seek doctors or attorneys by asking their friends, organizations usually begin the search for an auditor by contracting similar nonprofit organizations for referrals. Ideally, an auditor is familiar with nonprofit accounting and perhaps with the specific field in which the organization works. Organizations often prepare a brief description of their accounting systems and send out letters to five or six accounting firms asking for bids. It is a good idea to solicit bids from sole practitioners or small firms as well as from medium and large accounting firms.

Accounting firms that are interested will bid for the audit. The bid will be based on many factors, including the budget size of the organization, the condition of the books, the complexity of financial reports and transactions, the distance the accountant has to travel, the billing rates of the accounting firm, and the deadline by which the audit must be completed.

After receiving the bids, the organization normally interviews the auditor face to face and makes a selection based on the price, scope of work, their impression of the auditor's knowledge and personality and audit firm's references from similar type nonprofit organizations. **It is a good idea to ask for an audit firm's latest peer review report**. All CPAs who conduct GAGAS and A-133 audits must participate in a peer review program, where another CPA reviews the quality of their work and issues a report on such review. CPAs who do not perform such audits and limit their practices to GAAS audits, review and compilations do not have to participate in such a program, however, they can voluntarily participate in such programs. Participation in a peer review program by a small CPA firm is an indication of the firm's commitment to providing quality service.

Once the selection process is completed, the auditor typically sends an engagement letter to be signed by the nonprofit organization and a list of items that should be provided for the audit. Some of the audit work will be done at the nonprofit organization's office while some will be done at the auditor's office.

Preparing for an Audit

If the auditor does not provide a list of items needed together with the engagement letter, the nonprofit organization should ask for such a list prior to start of the audit work. For example, the auditor may need a list of equipment along with serial numbers, dates of purchase, or a list of bank accounts, etc. The auditor may ask for documents such as board minutes, copy of accounting manual, personnel manual or other similar procedural documents.

Keep in mind that an audit is not the final step to the bookkeeping. The Bookkeeping tasks should be completed, i.e., all bank account balances should be reconciled with the bank balances, all assets and liability accounts should be analyzed, liabilities should be recorded, expenses should be properly allocated, etc. prior to the start of the audit. In another words, the less work the CPA has to do, because the staff has done a thorough job, the less the cost.

In short, preparation for the audit has two focal points: putting things in order, and preparing documentation for items on the financial statements. In addition, accounting, executive, program and fundraising staff members should be aware that they will need to spend time with the auditor and be available to answer questions.

Working with an auditor is an opportunity to learn about accounting problems and improve accounting and control systems. The auditor can be an important resource to your organization if you choose your auditor carefully and work to develop a cooperative relationship.

Compliance

Uniform Administrative Requirements

Circular A-110, Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations, addresses various rules regarding the proper administration of federal awards by nonprofit organizations. A revised version of OMB Circular A-110 was published on August 29, 1997. The Office of Management and Budget (OMB) granted discretion to federal agencies in implementing Circular A-110. This was done so that each agency could adequately meet the special needs associated with its programs. As a result, many federal agencies implemented OMB Circular A-110 with modifications from the standard circular.

The administrative rules of Circular A-110 are organized into four parts:

A. ***General***: Primarily is comprised of definitions of frequently used terms. It also includes a rule explaining that all provisions of Circular A-110 also apply to all subawards where the subrecipient is a nonprofit organization. The Housing and Urban Development apply the provisions of A-110 to commercial entities as well.

B. ***Pre-award requirements***: Includes descriptions of the forms required to apply for financial assistance and other policies and rules regarding debarment and suspension, certifications and representation made during the pre-award stages, and other special conditions.

C. ***Post-award requirements***: Represents the largest and most important of the financial considerations of Circular A-110. This section includes standards for program and financial management, revisions to program budgets and plans, cost sharing and matching rules, financial and program reporting, property management standards, audits, record retention, and procurement standards.

D. ***After-the-award requirements***: Describes the closeout procedures, adjustments and settlements of balances due upon the completion of a program.

Sources of Cost Principles

Cost principles applicable to exempt organizations receiving federal financial assistance generally originate from OMB Circular A-122 and OMB Circular A-87, depending on whether the organization is a nonprofit organization or a state, local and Indian Tribal Government. However, as mentioned before, most significant differences between these circulars have been eliminated in recent years.

In the following sections some of the more important or unusual requirements of certain section of OMB A-110 and OMB A-122 will be highlighted.

General requirements for an accounting system

Receipt of federal funds adds many requirements to an organization's accounting system. A few of the most important principles of a strong grant accounting system include:

- Segregation of unallowable costs from allowable costs
- Segregation of direct from indirect cost
- Matching of income and applicable credits with associated expenditures
- Sound internal controls over purchases, cash disbursements, and cash receipts, including segregation of duties and proper authorizations and approvals of transactions
- Timely reconciliations of accounts and sub-ledgers
- Time-charging systems that comply with OMB Circular A-122
- Monitoring of actual results against budgets and award limitations
- Consistency in accounting treatment over time and from one function or award to another.
- Timely and accurate summary financial reporting
- Periodic internal and external audits or evaluations
- Maintenance of proper supporting documentation for all transactions, estimates, and calculations
- Record retention policies that comply with OMB Circular A-110
- Documentation of accounting policies, particularly those pertaining to cost-charging, timesheet preparation, and procurement.

Labor time-charging systems

The largest component of direct cost associated with most awards received by nonprofit organizations is labor. Therefore, it is critical that labor charges be properly documented in order to assure their allowability. OMB Circular A-122 requires that time or activity reports be maintained by all employees who charge their time, in whole or in part, directly to any federal awards, and by all other employees who charge time to two or more functions or activities where the allocation of their compensation between functions or activities is necessary to determine the organization's indirect cost.

Circular A-122 states that reports maintained by organizations to satisfy these requirements must meet the following standards:

- The reports must reflect an after-the-fact determination of the actual activity of each employee. Budget estimates do not qualify as support for charges to awards.
- Each report must account for the total activity for which employees are compensated and which is required in fulfillment of their obligations to the organization.
- The reports must be signed by the individual employee, or by a responsible supervisory official having first hand knowledge of the activities performed by the employees, that the distribution of activity represents a reasonable estimate of the actual work performed by the employee during the periods covered by the report.
- The reports must be prepared at least monthly and must coincide with one or more pay periods.

To support other compensation costs, OMB Circular A-122 makes reference to each of the following additional requirements in its discussion of compensation and employee benefits:

- "Written organization policies" are required that govern employer contributions or expenses for social security, employee insurance, workers' compensation insurance, pension plan costs and similar items.
- Compensation must conform to "established policy" of the organization in order to be allowable. In addition, those policies must be consistently applied.
- Incentive compensation is an allowable cost only if paid "pursuant to an agreement" entered into between the organization and the employee prior to the rendering of the services or "pursuant to an established plan" consistently followed by the organization.

Cash Management

Recipients and subrecipients are required to have procedures in place to minimize the amount of time that elapses between receipt of federal funds and the actual disbursement of those funds.

This requirement is intended to curtail unnecessary drawdowns of federal funds and minimize the cost of financing the federal program by the federal government. There are three general methods available to transfer federal funds from the U.S. Treasury to recipients (or from the recipient to a subrecipient):

- ***Reimbursement method*** - The reimbursement method entails a transfer of grant funds to the recipient (or subrecipient) based on actual expenditures of the recipient prior to the receipt of CDBG funds.
- ***Cash advance method*** - The cash advance method involves the transfer of CDBG funds to the recipient (or subrecipient) to meet obligations before actual cash disbursements have been made.
- ***Working capital method*** - The recipient (or subrecipient) is advanced cash to meet its estimated disbursements for an initial period. After the initial period, the recipient/subrecipient will receive cash on a reimbursement basis. This method is used when the recipient/subrecipient lacks sufficient working capital.

Requirements concerning cash management include the following:

- Recipients (and subrecipients) must include accurate information in drawdown requests.
- Funds drawn down erroneously must be returned. (This includes funds drawn down under the cash advance method where the expenditure of funds is delayed.)
- Disbursement of funds must occur in a timely manner. While there is no explicit time period, the general rule is that payment must take place within three business days of deposit of federal funds. If payment takes longer than three business days, written justification should be maintained in the files.
- If a nonprofit organization has received advances of federal funds, such funds must be kept in an interest-bearing, insured account unless one of the following three conditions exist:

   1. The nonprofit organization receives less than $120,000 in federal awards per year.

2. The best reasonably available interest bearing account would not be expected to earn interest in excess of $250 per year on federal cash advances.

3. The depository would require an average or minimum balance so high that it would not be feasible within the expected federal and non-federal cash resources.

Property Management and Disposition

Standards for the management of property used in program activities are described in sections .30 through .37 of subpart C of OMB Circular A-110. Among the most crucial or frequently overlooked property management standards are the following:

- Property records for equipment should be maintained that include descriptions of the equipment, serial numbers, models numbers, source of the equipment by award number, an indication of whether title to the equipment vests in the recipient or the federal government, acquisition dates and costs, information regarding the percentage of federal participation in the cost, location and condition of the equipment, and information regarding the ultimate disposition of the equipment.
- Equipment that is owned by the Federal Government must be marked as such.
- Nonprofit organizations must provide equivalent insurance coverage for real property and equipment acquired with federal funds as provided to property owned by the organization.
- A physical inventory of equipment must be taken at least once every two years and reconciled to the equipment records. As part of this inventory, recipients must verify the existence, current utilization, and continued need for the equipment.
- Title to real property and equipment acquired with federal funds generally lies with the nonprofit organization, provided that the property is used only for its authorized purpose. At the conclusion of the program for which the property was used, the nonprofit organization may be permitted to keep the property under the following criteria:

  1. For real property, the organization should request disposition instructions from the federal agency, which may direct any of the following:

     a. Allow the organization to retain the property after compensating the government for its share of the fair market value as of the date the program concluded.

     b. Require the organization to sell the property and remit a portion of the proceeds to the federal government based on its participation in the program.

c. Transfer title to the property back to the federal government or some eligible third party, with the organization receiving compensation based on the fair market value and the organization's percentage participation in the program.

2. For equipment with a current per unit fair market value of $5,000 or less at the conclusion of a program, the organization may keep or sell the equipment without compensating the government. If the value is $5,000 or higher, the organization must compensate the federal government in an amount equal to the fair market value times the federal government's original percentage participation in the program. If the organization has no use for the equipment, it should request disposition instructions from the government agency.

3. Similar logic applies to residual inventories or supplies (i.e., if aggregate fair market value of all remaining supplies is less than $5,000, the organization may retain or sell without compensating the federal government).

4. In cases where the nonprofit organization compensates the federal government for the residual value of equipment or inventory under b or c, the organization may retain an amount for selling and handling charges equal to the lesser of $500 or 10% of the proceeds.

Cost Principles

LOOK AT YOUR AGENCY AND ASK...

Does your agency have a clearly defined set of standards and procedures for determining the reasonableness, allowability and allocability of costs incurred that is consistent with OMB A-87 or OMB A-122? Does your agency know which specific types of expenditures are prohibited under the CDBG program? Does your agency have an indirect cost allocation plan or proposal?

Cost Allowability, Allocability, and Reasonableness

In order to be allowable under a federal award, costs must meet several criteria:

- The cost must be reasonable for the performance of the award and allocable to it. The terms "reasonable" and "allocable" are defined below.

- The cost must conform to any limitations or exclusions of the OMB circular or the award itself.
- Treatment of costs must be consistent with the policies and procedures that apply to both Federally financed activities and other activities of the organization.
- The cost must be determined in accordance with generally accepted accounting principles.
- Cost may not be included as a cost of any other Federally financed program in the current or prior periods.
- The cost must be adequately documented.

Costs are considered to be "**reasonable**" if they do not exceed that which a prudent person would incur under similar circumstances. In determining the reasonableness of a cost, consideration must be given to:

- Whether the cost is of the type generally recognized as ordinary and necessary for the operation of the organization for the performance of the award;
- The restraints or requirements imposed by such factors as: generally accepted sound business practices; arms length bargaining; federal and state laws and regulations; and terms and conditions of the award;
- Market prices for comparable goods or services;
- Whether the individuals concerned acted with prudence in the circumstances, considering their responsibilities to the organization, its members, employees and clients, the public at large and the government; and
- Significant deviations from the established practices of the organization which may unjustifiably increase the award costs.

Allocability of costs pertains to the relative benefit received from incurring the cost. Costs are considered to be allocable to a Federal award if they fall into any one of the three categories:

- Costs that are incurred specifically for the award (direct costs)
- Costs that benefit both the award and other work, and can be distributed in reasonable proportion to the benefits received (overhead)
- Costs which are necessary to the overall operation of the organization, but, where a direct relationship to any particular program, or group of programs, cannot be shown (shared)

The OMB circulars also specify exactly which costs are allowable and which are unallowable.

- Exhibit 4-2 summarizes allowable and unallowable costs. Note: this is intended only as a summary; refer to the OMB circulars for complete information.

Direct vs. Indirect Costs

Direct costs are those that can be identified with a specific final cost objective. Cost objectives include each program, whether supported by a Federal award or not, an also include supporting activities of the organization, such as fund-raising and administration activities. Accounting systems need to properly segregate direct costs associated with each cost objective of an organization.

Indirect costs are those costs that have been incurred for common or joint objectives and cannot readily be identified with any one particular cost objective. Examples include occupancy costs, office supplies, clerical and administrative salaries, depreciation of assets used for common objectives, general insurance, repairs and maintenance, accounting and legal fees and other similar costs.

Indirect Cost Allocation Methods

OMB Circulars A-87 and A-122 require that nonprofit organizations and governmental entities support indirect costs with a cost allocation plan or an indirect cost proposal prepared in accordance with these circulars. Indirect costs should be allocated in a manner that result in the grant program bearing its fair share of total indirect costs. The methods for allocating indirect costs are many in number and varying in complexity. OMB Circulars A-87 and A-122 identify three acceptable methods of allocating indirect costs.

- Simplified allocation method
- Multiple allocation base method
- Direct allocation method

Simplified allocation method is used by many small nonprofit organizations and by organizations whose major functions benefit from its indirect costs to approximately the same degree. The primary steps for using the simplified allocation method are as follows:

1. Identify all costs as either direct or indirect.
2. Allocate allowable indirect cost using an equitable distribution base, such as total direct cost, direct labor, etc.

3. Exclude capital expenditures and other distorting items of cost, such as major subcontracts or subgrants.

4. Use the resulting indirect cost rate to distributed indirect costs to individual awards.

Organizations receiving more than $10 million in federal funding of direct costs in a fiscal year must break out total indirect costs into "facilities" and "administration".

Multiple Allocation Based Method can be significantly more complicated than the simplified allocation method. It is typically required of organizations where indirect costs benefit programs or activities of the organization in varying degrees. Under this method costs are classified into cost pools formed based on the homogeneity (i.e., costs that are of like character in terms of the functions they benefit). There is no limit to the number of cost pools. The multiple allocation based method takes the same logic introduced under the simplified method and extends it further to arrive at what should be more accurate and fairer indirect cost allocation. Examples of cost pools are:

- Fringe benefits
- Occupancy costs
- General and administrative costs
- Executive management

Direct Allocation Method incorporates the following characteristics:

- All costs are treated as direct, except for general and administration costs that represent the only indirect costs of the organization.
- Typical joint costs, such as rent, depreciation, telephone, maintenance, etc. are individually prorated to functions (administration, fund raising, other direct functions) as direct costs using a base most appropriate to each particular cost.

Types of Indirect Cost Rates

The manner in which indirect cost rates are used once they are agreed upon can differ depending on the arrangement an organization has with a federal agency. Three types of indirect cost rates may be utilized:

1. **Provisional/Final Rates** — Provisional rates are temporary rates that are used for billing purposes during a period. These rates are adjusted to final rates at the conclusion of a fiscal period based on actual cost incurred. If provisional rates are higher than final rates, the organization owes money back to the federal agency. Likewise, if the final rates exceed provisional rates, the nonprofit organization will receive additional funds from the federal agency, as long as limitations of the award are not exceeded.

2. **Predetermined Rates** — Predetermined rates are fixed. They are not adjusted based on actual costs incurred.

3. **Fixed Rate with Carry-Forward** - Under this method, an organization may adjust its estimated rates to actual rates, however, it is not required to recover or pay back retroactive adjustments as it would under the provisional/final rates nor must it commit itself to a predetermined rate and potential for under-recovery that comes with that type of rate. Fixed rates with carry-forwards are typically used only with grant recipients with stable histories and long-term relationships with federal agencies.

ALLOWABLE AND UNALLOWABLE COSTS UNDER OMB A-122

Item of Cost	OMB A-122 (nonprofits) Unallowable	OMB A-122 (nonprofits) Allowable
Accounting	N/A	
Advertising		✔*
Advisory councils	N/A	
Alcoholic beverages	✔	
Audit services	N/A	
Automated electronic data processing	N/A	
Bad debts	✔	
Bonding		✔
Budgeting	N/A	
Communication		✔
Compensation, personnel services		✔*
Contingency provisions/reserves	✔	
Contributions (to others)	✔	
Defense & prosecution of criminal & civil proceedings & claims		✔*
Depreciation, use allowance		✔
Disbursing service	N/A	
Donations (from others)	✔	
Employee morale, health, welfare		✔
Entertainment	✔	
Equipment		✔**
Fines, penalties		✔*
Fringe benefits		✔
Fund raising	✔	
Investment management	✔	
Goods or services for personal use	✔	
Housing and personal living expense	✔	
Gains and losses on disposition of property	N/A	
General government expenses	N/A	
Idle facility, idle capacity		✔*
Insurance & indemnification		✔*
Interest		✔*
Labor relations		✔
Lobbying	✔	
Losses on other awards	✔	
Maintenance, operations, and repair		✔
Materials, supplies		✔
Memberships, meetings & conferences subscriptions, professional activity		✔

Item of Cost	OMB A-122 (nonprofits) Unallowable	OMB A-122 (nonprofits) Allowable
Motor pools	N/A	
Organization costs		✔**
Overtime, shift premiums		✔*
Page charges in professional journals (research)		✔
Participant support costs		✔**
Patent costs		✔*
Pension plans		✔
Plant security		✔
Pre-award costs		✔**
Professional services		✔*
Proposal costs	N/A	
Profits, losses on asset disposition		✔*
Publication and printing costs		✔***
Rearrangement, facility alteration		✔**
Reconversion costs		✔
Recruiting		✔*
Relocation		✔*
Rental		✔*
Royalties, use of patents, copyrights		✔*
Selling and marketing		✔***
Severance pay		✔*
Specialized service facilities		✔
Taxes		✔*
Termination-related costs		✔*
Training, education		✔*
Transportation		✔
Travel		✔*
Trustees		✔
Underrecovery of costs under federal agreements	N/A	

N/A: not applicable (not specifically addressed in the circular)

* *Allowable under limited circumstances.*

** *Allowable only with prior permission from the grantee.*

*** *Allowable only as a direct cost with permission from the grantee.*

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State and Federal Reporting Requirements

Although nonprofit organizations are not subject to income taxes on the net income from their related business activities — i.e., the activities that are related to their exempt purpose — they are nevertheless required by the Internal Revenue Service and similar State taxing authorities to file the following income tax returns for monitoring purposes:

Form 990 and Schedule A

Form 990 and schedule A of this form are due on the fifteenth day of the fifth month after the close of the accounting year. This return should be filed with the Internal Revenue Service on an annual basis, unless gross receipts of the organization is normally less than $25,000.

Organizations are not required to register beyond their initial application with the Secretary of State of Texas. Texas does not impose a corporate income tax or require nonprofit organizations to file any annual informational returns. For further information contact:

Secretary of State:
Questions about other tax exemptions (512) 463-4600

In addition, all nonprofit organizations are liable for payroll taxes, sales taxes, and any other taxes that are levied against businesses.

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Exhibit 1: Internal Controls Checklist

	Yes	No	Not Sure	Not Applicable
Cash Receipts				
1. Are checks endorsed “for deposit only” immediately upon receipt?				
2. Does someone prepare a daily list of all cash and checks immediately upon receipt?				
3. Are duplicate deposit slips and copies of checks retained in the files?				
4. Is the person who has custody of actual cash and checks different from the person recording them and acknowledging them in case of contributions?				
5. Are all cash and checks deposited intact and on a timely basis?				
6. Are restricted contributions clearly identified and recorded as restricted on the general ledger?				
7. Is all cash received, counted and verified by two employees?				
8. When events involve admission fees, does the agency issue pre-numbered tickets, with a record of tickets printed, issued, used and unused, which is then compared to funds deposited?				
9. Does the organization send acknowledgements to contributors and are copies of or record of such acknowledgements kept on file?				

	Yes	No	Not Sure	Not Applicable
Cash Disbursements				
10. Are all disbursements, except those from petty cash, made by pre-numbered checks?				
11. Are voided checks preserved and filed after appropriate mutilation?				
12. Is there a written prohibition against drawing checks payable to "cash"?				
13. Is there a written prohibition against signing checks in advance?				
14. Is a cash disbursement voucher prepared for each invoice or request for reimbursement that details the description of expense account to be charged and contains authorization signature and accompanying receipts and/or vendor invoices?				
15. Are all expenses approved in advance by authorized persons?				
16. Do the check signors review supporting documentation of expenses and approvals before signing checks?				
17. Are signed checks mailed promptly?				
18. Are paid invoices marked paid or attached to a copy of the check prior to filing?				
19. Are requests for reimbursement checked for mathematical accuracy and reasonableness before approval?				
20. Is check-signing authority vested in persons at appropriately high levels in the organization who do not have any accounting responsibility?				
21. Do checks require two signatures?				
22. Are bank statements and cancelled checks received and reviewed by a person independent of the accounting functions?				
23. Are unpaid invoices maintained in an unpaid invoice file?				
24. Is a list of unpaid invoices regularly prepared and reviewed?				
25. If purchase orders are used, are all purchases supported by a pre-numbered purchase order?				

	Yes	No	Not Sure	Not Applicable
Cash Disbursements *(continued)*				
26. Are advance payments to vendors and/or employees recorded as receivables and controlled in a manner which assures that they will be offset against invoices or expense vouchers?				
27. Are employees required to submit expense reports for all travel related expenses on a timely basis?				
Petty Cash				
28. Is an imprest petty cash fund maintained for payment of small, incidental expenses?				
29. Does the organization follow a policy limiting the amount that can be reimbursed by the petty cash fund?				
30. Is supporting documentation required for all petty cash disbursements?				
31. Is a petty cash voucher filled out with supporting documentation, name of person being reimbursed, and proper authorization?				
32. Is access to petty cash limited to one person who is the fund custodian?				
33. Are unannounced counts of petty cash made by someone within the organization other than the fund custodian?				
Payroll				
34. Are time sheets required documenting employee hours, overtime and what activity the employee worked on?				
35. Are time sheets signed by employees and reviewed and signed by their immediate supervisors?				
36. Are employment records maintained for each employee that detail wage rates, benefits, tax rates, and other pertinent information?				
37. Are withheld employment taxes and employer taxes paid on a timely basis to the taxing authorities?				
38. Do written policies and procedures exist for accounting for vacations, holidays, sick leave, and other benefits?				

	Yes	No	Not Sure	Not Applicable
Fixed Assets				
39. Does the organization have a capitalization and depreciation policy?				
40. Are additions to fixed assets recorded in a fixed asset ledger?				
41. Does the fixed asset ledger list description of each item, serial number, location, date of acquisition, cost or fair value if donated, useful life, depreciation method, accumulated depreciation and funding source if title remains with the grantor?				
42. Is the fixed asset ledger reconciled with the general ledger periodically?				
43. Are purchase, transfer and disposal of fixed assets promptly recorded in the ledger?				
44. Does the organization conduct a physical inventory annually and update the fixed asset ledger?				
Financial Statements				
45. Is a statement of financial position prepared monthly and reviewed by the management and the finance committee?				
46. Are monthly reports comparing income and expenses with approved budget by activity prepared and reviewed by the management and the finance committee?				
47. Is an updated cash flow projection prepared and reviewed by the management and the finance committee?				
General Area				
48. Is a chart of accounts used?				
49. Is fund accounting used to track restricted grants and their spending?				
50. Are accounting records up to date, and monthly financial statements prepared on a timely basis (timely being defined as 10 days to 3 weeks maximum)?				
51. Does the board of directors approve the annual budget?				
52. Does an accounting procedure and policies manual exist that is reviewed and revised annually?				

	Yes	No	Not Sure	Not Applicable
General Area *(continued)*				
53. Do accounting staff take annual vacation and are their basic duties performed by someone else in their absence?				
54. Are all appropriate federal, state, and local information returns filed on a timely basis?				

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Exhibit 2: Staffing Patterns

TASKS	VOLUNTEER GROUP All volunteer, small organization. Books kept by volunteer treasurer	SMALL ORGANIZATION 5 full time staff, including admin. Assistant (AA). Monthly accounting work done by outside accountant	MID-SIZED ORGANIZAITON 15 full time staff, including full-time bookkeeper	LARGER ORGANIZATION 30+ full time staff including full time finance manager, full time bookkeeper, and accounting clerk
Open mail, endorse checks	President or person who receives mail	Executive Director	Receptionist	Receptionist
Record deposits	Treasurer	Outside accountant	Bookkeeper	Accounting clerk
Acknowledge contributions	President	Executive Director	Fundraiser	Fundraiser
Receive bills in the mail	President/Treasurer	AA	Bookkeeper	Accounting clerk
Authorize bills for payment	President/Treasurer	Executive Director	Executive Director/program managers	Executive director/program managers
Prepare checks	Treasurer	AA	Bookkeeper	Bookkeeper
Sign checks	President	Executive Director	Executive Director	Finance manager and Executive Director
Prepare payroll	Not applicable	AA	Bookkeeper	Bookkeeper
Record bills and checks	Treasurer	Outside accountant	Bookkeeper	Bookkeeper
Reconcile bank balances	Treasurer	Outside accountant	Bookkeeper	Finance manager
Prepare journal entries	Treasurer	Outside accountant	Bookkeeper	Bookkeeper/Finance manager

Exhibit 2: Staffing Patterns

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entries		accountant		nce manager
Prepare monthly financial statements	Treasurer	Outside accountant	Bookkeeper	Bookkeeper/Fina nce manager
Monitor budget	President/Treasur er	Executive Director	Executive Director/program managers	Executive Director/Finance Manager and program managers
Present finance reports to the board	Treasurer	Executive Director	Executive Director	Finance Manager
Project and manage cash flow	Treasurer	Executive Director	Executive Director	Finance Manager
Prepare and file annual tax forms	Treasurer or hired CPA	Outside accountant	Bookkeeper or hired CPA	Finance manager or hired CPA

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Exhibit 3: Cash Flow Projection

SUPPORTIVE HOUSING, INC.

Cash Flow Projection

For the Period of January 1 through May 31, 2001

	Jan	Feb	Mar	Apr	May
Cash - Beginning of the month	15,814	(9,086)	50,914	34,914	31,414
Cash receipts					
Individual donations	2,000	1,000	500	5,000	2,500
Grants - S.F. Foundation	0	100,000	0	0	0
Grants - Hewlett Foundation	0	0	20,000	0	0
Grants - Irvine Foundation	7,500	0	0	7,500	0
Grants - Corporations	0	0	0	30,000	20,000
Rental income	23,000	25,000	24,000	23,000	21,000
Total cash receipts	32,500	126,000	44,500	65,500	43,500
Cash disbursements					
Salaries	40,000	40,000	40,000	40,000	40,000
Payroll taxes and benefits	4,000	4,000	4,000	4,000	4,000
Maintenance & repairs	5,900	3,000	2,000	15,000	3,000
Rent	5,000	5,000	7,000	7,000	7,000
Postage	0	1,500	0	500	250
Office supplies and other	1,000	1,000	1,000	1,000	2,000
Insurance	0	0	5,000	0	0
Purchase of equipment	0	10,000	0	0	0
Payment on loans	1,500	1,500	1,500	1,500	1,500
Total cash disbursements	57,400	66,000	60,500	69,000	57,750
Net increase (decrease) in cash	(24,900)	60,000	(16,000)	(3,500)	(14,250)
Cash — End of the month	(9,086)	50,914	34,914	31,414	17,164

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Exhibit 4: Statement of Financial Position

SUPPORTIVE HOUSING, INC.

Statement of Financial Position
At December 31, 2000

Assets			
Current Assets			
Cash	51,848		
Accounts receivable	24,819		
Grants receivable	37,500		
Prepaid expenses	9,328		
Total current assets			123,495
Property and equipment	168,723		
Accumulated depreciation	(42,875)		125,848
Total Assets			249,343
Liabilities			
Current Liabilities			
Accounts payable	51,916		
Payroll taxes payable	14,938		
Current portion of notes payable	15,000		
Total current liabilities		81,854	
Notes payable - Long-term		82,813	
Total Liabilities			164,667
Net Assets			
Unrestricted			
Designated for capital improvements	10,000		
Available for operations	24,676	34,676	
Temporarily restricted		50,000	
Permanently restricted		0	
Total Net Assets			84,676

Total Liabilities And Net Assets	249,343

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Exhibit 5: Statement of Activities

SUPPORTIVE HOUSING, INC.

Statement of Activities

For the Year Ended December 31, 2000

	Unrestricted	Temporarily restricted	Total
Support and Revenue			
Contributions	250,568	14,000	264,568
Foundation and corporation grants	87,500	70,000	157,500
Rental income	245,321	0	245,321
Interest and other revenue	1,778	0	1,778
Net assets released from restrictions:			
Purpose accomplished	14,000	(14,000)	0
Time expired	20,000	(20,000)	0
Total Support and Revenue	619,167	50,000	669,167
Expenses			
Program Services			
Transitional housing	157,539	0	157,539
Permanent housing	178,561	0	178,561
Supportive services	164,183	0	164,183
Supporting Services			
Administration	94,591	0	94,591
Fund raising	31,245	0	31,245
Total Expenses	626,119	0	626,119
Change in net assets	(6,952)	50,000	43,048
Net assets — Beginning of the year	41,628	0	41,628
Net assets — End of the year	34,676	50,000	84,676

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Exhibit 6: Statement of Functional Expenses

SUPPORTIVE HOUSING, INC.

Statement of Functional Expenses

For the Year Ended December 31, 2000

(Case-by-Case Method of Shared Cost Allocation)

	Transitional Housing	Permanent Housing	Supportive Services	Admin	Fund-Raising	Total
Salaries	118,288	97,399	104,769	68,979	20,385	409,820
Payroll taxes	11,834	9,837	10,567	6,882	2,073	41,193
Employee benefits	7,097	5,844	6,287	4,138	1,223	24,589
Maintenance & repairs	1,000	44,070	1,040	600	3,700	50,410
Rent	9,428	10,936	9,805	5,657	1,886	37,712
Postage	4,643	5,385	4,828	2,786	929	18,571
Office supplies	2,450	4,002	3,588	2,070	690	12,800
Advertising & promotion	1,000	0	13,714	0	0	14,714
Insurance	900	1,044	8,650	2,940	180	13,714
Depreciation	900	1,044	936	540	180	3,600
Total	157,540	179,561	164,184	94,592	31,246	627,123

(Allocation Rate Method of Shared Cost Allocation)

	Transitional Housing	Permanent Housing	Supportive Services	Admin.	Fund-raising	Shared Costs	Total
Salaries	90,250	64,875	75,610	52,156	14,777	112,150	409,818
Payroll taxes	9,030	6,585	7,651	5,200	1,512	11,215	41,193
Employee benefits	5,415	3,893	4,537	3,129	887	6,729	24,590
Maintenance & repairs	0	42,910	0	0	0	4,000	46,910
Rent	0	0	0	0	0	37,710	37,710
Postage	0	0	0	0	3,500	18,570	22,070
Office supplies	0	0	0	0	0	12,800	12,800
Advertising & promotion	0	0	13,714	0	0	1,000	14,714
Insurance	0	0	7,714	2,400	0	3,600	13,714
Depreciation	0	0	0	0	0	3,600	3,600
Total before allocation	104,695	118,263	109,226	62,885	20,676	211,374	627,119
Shared cost allocation	52,844	61,298	54,957	31,706	10,569	(211,374)	0

Total after allocation	157,539	179,561	164,183	94,591	31,245	0	627,119

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Exhibit 7:
Actual Income and Expenses vs. Budget (Format 1)

SUPPORTIVE HOUSING, INC.

Actual Income and Expenses vs. Budget

Transitional Housing

For the Year Ended December 31, 2000

(Format 1)

	Month			Year-to-Date		
	Actual	**Budget**	**Variance (Unfavorable)**	**Actual**	**Budget**	**Variance (Unfavorable)**
Support & Revenue						
Contributions	0	850	(850)	6,897	10,000	(3,103)
Foundation grants	0	0	0	68,000	30,000	38,000
Rental income	5,591	6,250	(659)	64,696	75,000	(10,304)
Interest and other revenue	0	0	0	0	0	0
Net assets released from restrictions:						
Purpose accomplished	0	0	0	7,000	10,000	(3,000)
Total Support & Revenue	5,591	7,100	(1,509)	146,593	125,000	21,593
Expenses						
Salaries	7,520	7,500	(20)	90,250	90,000	(250)
Payroll taxes	726	750	24	9,030	9,000	(30)
Employee benefits	450	600	150	5,415	5,000	(415)
Shared cost allocation	4,445	4,250	(195)	52,844	51,000	(1,844)
Total Expenses	13,141	13,100	(41)	157,539	155,000	(2,539)
Surplus (deficit)	(7,550)	(6,000)	(1,550)	(10,946)	(30,000)	19,054

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Exhibit 8:
Actual Income and Expenses vs. Budget (Format 2)

SUPPORTIVE HOUSING, INC.

Actual Income and Expenses vs. Budget

Transitional Housing

For the Year Ended December 31, 2000

(Format 2)

	Actual Month	Actual Year-to-Date	Annual Budget	$ Over (under) Budget	% Over (under) Budget
Support & Revenue					
Contributions	0	6,897	10,000	(3,103)	-31%
Foundation grants	0	68,000	30,000	38,000	127%
Rental income	5,591	64,696	75,000	(10,304)	-14%
Interest and other revenue	0	0	0	0	0%
Net assets released from restrictions: Purpose accomplished	0	7,000	10,000	(3,000)	-30%
Total Support & Revenue	5,591	146,593	125,000	21,593	52%
Expenses					
Salaries	7,520	90,250	90,000	250	0%
Payroll taxes	726	9,030	9,000	30	0%
Employee benefits	450	5,415	5,000	415	8%
Shared cost allocation	4,445	52,844	51,000	1,844	4%
Total Expenses	13,141	157,539	155,000	2,539	2%
Surplus (Deficit)	(7,550)	(10,946)	(30,000)	19,054	

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