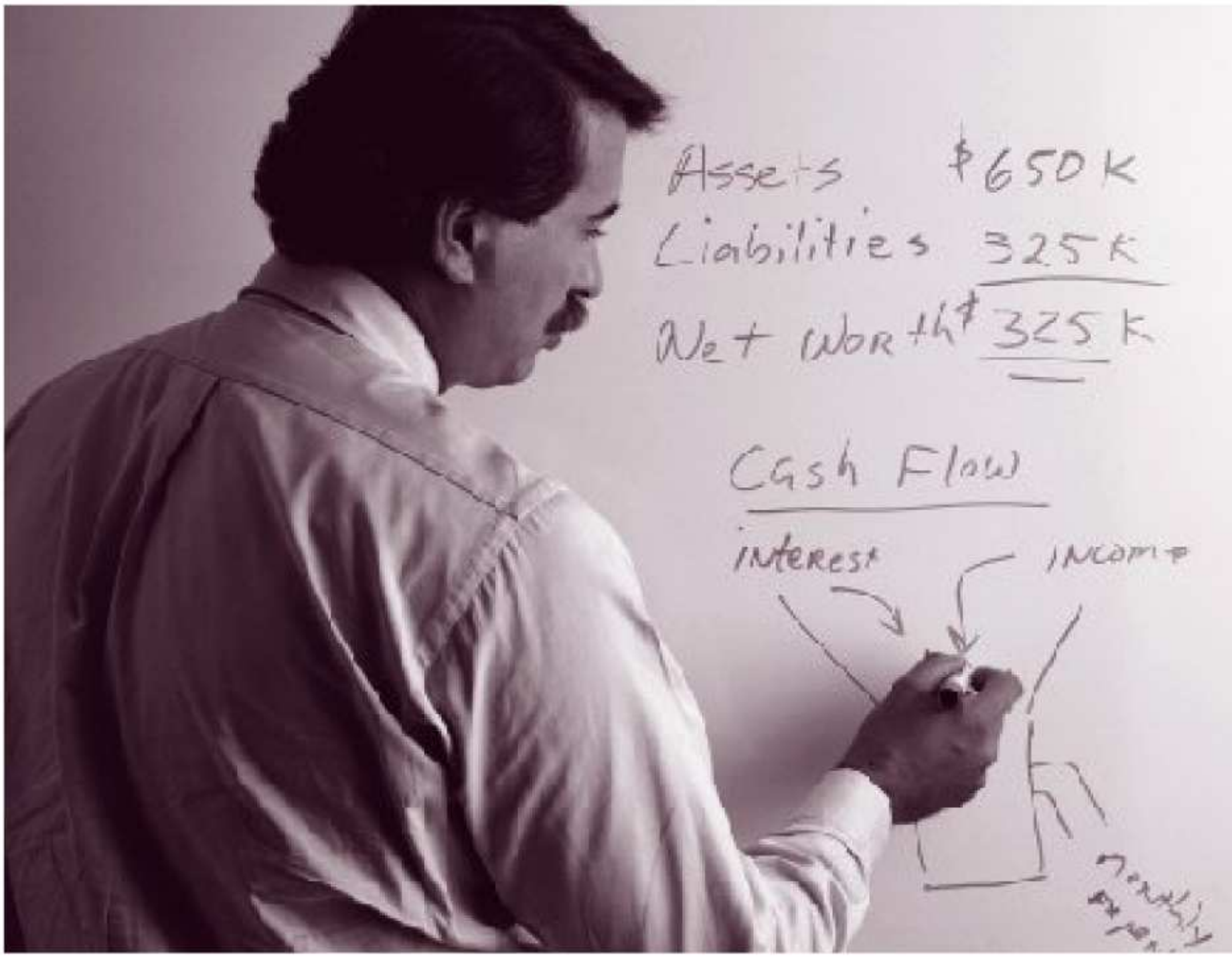
THE ENTERPRISE FOUNDATION

Sound Financial Management

MONEY
MANAGEMENT



An Overview of Basic Accounting and Financial Principles
for Nonprofit Community Development Organizations

Launched in 1982 by Jim and Patty Rouse, The Enterprise Foundation is a national, nonprofit housing and community development organization dedicated to bringing lasting improvements to distressed communities.

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COMMUNITY DEVELOPMENT LIBRARY™

This book is part of the Enterprise Community Development Library, an invaluable reference collection for nonprofit organizations dedicated to revitalizing and reconnecting neighborhoods to mainstream America. One of many resources available through Enterprise, it offers industry-proven information in simple, easy-to-read formats. From planning to governance, fund raising to money management, and program operations to communications, the Community Development Library will help your organization succeed.

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The Enterprise Foundation provides nonprofit organizations with expert consultation and training as well as an extensive collection of print and online tools. For more information, please visit our Web site at www.enterprisefoundation.org.

THE ENTERPRISE FOUNDATION

About This Manual

What is sound financial management?

Sound financial management requires careful tracking and prudent management of your organization's financial resources and cash flows. With good financial management, an organization can understand its costs and incomes; without it, an organization compounds any operational problems and invites additional outside scrutiny.

Sound Financial Management is designed for the staffs and boards of nonprofit community development organizations; city, county and state agencies; and technical assistants and partners of nonprofit community development organizations. This guide explains the elements of good financial management, including:

- Charts of accounts
- The science of accounting
- Financial reporting
- When to use accounting services
- Nonprofit status
- Unrelated business income
- Internal controls
- Tax-exempt status

Not intended as an in-depth text, *Sound Financial Management* provides an overview of the different aspects of financial management, written from the standpoint of a nonprofit manager or board member who is not familiar with accounting or the details of financial management.

This manual is one of the books within the *Money Management* series of The Enterprise Foundation's Community Development Library™. The series provides detailed information on:

- Budgeting
- Cash flow projections
- Accounting software
- Financial statements
- Assessing your organization's finances
- Federal rules of nonprofit money management

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Introduction

Financial management means properly *recording* all of the monetary (and some nonmonetary) transactions of your organization. Financial management also means *reporting* those transactions in standard forms that show the *financial position and performance* of your organization. And financial management means ensuring that the organization's funds are *safeguarded* and *used prudently,* now and in the future. It involves accounting, information management and planning. You must secure the funds you need to operate, record the activities of your operation, analyze the results on an ongoing basis and report on your activities and financial position. And you must repeat the process month after month and year after year.

Good financial management is both science and art, requiring accurate information and a good bit of creativity.

Many textbooks have been written on the topic of financial management. This is not intended to be another. Instead this simple guide is for those who lead nonprofit community development organizations and who have limited accounting and finance experience. The primary goal is to introduce several important concepts in financial management and to help you become familiar with the language. In addition, this manual points out topics that you may need to explore and study. Although financial expertise is not a requirement for most board members and staff, their effectiveness will be limited without a basic understanding of accounting and finance.

Good financial management is both science and art, requiring accurate information and a good bit of creativity. Public funds for community development are always too scarce, so many nonprofits find that they must be both efficient and effective users of this resource.

The Science of Accounting: Recording Transactions

Financial transactions are recorded in categories or *accounts* that describe the *assets, liabilities, revenues* and *expenses* of your operation. This listing of accounts and their identifying code numbers is called the *chart of accounts*. It is relatively standard for most businesses, but your chart of accounts should reflect the nature of *your* business. You may have a series of accounts for recording the expenses related to property management, for example, such as grounds maintenance and laundry expenses. A business of a different sort — manufacturing or retail — would omit these accounts but include others.

Using the identifying codes from the chart of accounts, financial transactions are recorded in *journals,* which are characterized by transaction type. You should have the following journals, which make up your official records:

Cash Receipts Log to record cash coming in and deposited in the bank

Payment Records to record cash payments to others (checkbook)

Payroll Register to record all payroll activities (gross pay, taxes withheld)

General Journal to record transactions outside the other categories (adjustments to balances, transfers between accounts)

Examples of each of these journals are at the end of this section.

The information from the journals is posted — recorded in summary or detail — to the *general ledger* (GL). The GL is the comprehensive record of all transactions for the organization. The journals and ledgers are commonly referred to as *the books*.

A bookkeeper or accountant can assist you in the proper use of these journals and the recording of transactions. If circumstances require that you perform this function yourself, it is a good idea to familiarize yourself with *debit and credit balancing,* the basis of standard accounting procedure. Most community colleges or community adult education centers offer inexpensive courses or seminars in basic accounting and bookkeeping. What follows is a simple introduction to accounting basics.

DEBITS = CREDITS

Financial transactions resulting from day-to-day activity are recorded as journal entries. *All* transactions are recorded chronologically in the *general ledger*. Later, the same information is recorded again, but this time it is grouped into account categories such as office supplies expense, cash or accounts payable. Office supplies expense transactions are recorded on one *standard account form*, and cash transactions are recorded on another. (Account categories are defined in the *chart of accounts*).

There are at least two sides to every journal entry — a debit and a credit. In the language of accounting, "debit" and "credit" do not refer to "decreasing" and "increasing" but rather to *positions* in the journal — the left and right side, respectively. Each transaction affects at least two accounts and will require a credit entry and an equal debit entry. Consider the following illustration.

Illustration:

The office manager has just bought $200 in office supplies, using a company check. The bookkeeper then records a decrease in *cash* by entering a credit (yes, a credit) and also an increase in *office supplies expense* by entering a debit. Debits must ***always*** equal credits. Here is how the transaction would look in the general journal.

Your Neighborhood Community Development Corporation

General Journal

					Page 1
Date		**Account Titles and Description**	**PR***	**Debit**	**Credit**
2000 Mar.	1	Cash			2 0 0 00
		Purchase of stationery			
	1	Office supplies expense		2 0 0 00	
		Purchase of stationery			

*PR stands for "Posting References" and identifies the ledger containing this item.

As you can see, the purchase affected two accounts: *Cash* has been diminished, while *office supplies expense* has increased.

As a result, the transaction is recorded on two account forms:

Account Title: Cash						Account No. 10600-100	
Date		**Explanation**	**PR**	**Debit**	**Credit**	**Balance**	
						Debit	Credit
2000 Mar.	1		G11		2 0 0 00		2 0 0 00

Account Title: Office Supplies Expense						Account No. 62100-100	
Date		**Explanation**	**PR**	**Debit**	**Credit**	**Balance**	
						Debit	Credit
2000 Mar.	1		G11	2 0 0 00		2 0 0 00	

MORE ABOUT DEBITS AND CREDITS

The principles of accounting define whether a given transaction should be recorded as a debit or a credit, and those principles are not obvious to the uninitiated. Transactions are recorded primarily in the following four account categories:

Assets are the "things" that an entity owns or has a right to claim (receivables) or use in the course of operations. They include cash, equipment, investments and inventory. Assets can be tangible (such as property) or intangible (such as patents).

Liabilities are obligations or debts that the entity owes to creditors, customers or other third parties. Liabilities may include accounts payable to vendors, loans from banks and security deposits from tenants.

Revenues are inflows of cash or other assets usually as a result of the delivery of services or fund-raising activities. Revenue, also called income, includes grants, donations, program fees, proceeds from the sale of property and rental income.

Expenses are outflows of cash or other assets as a result of the delivery of services or other activities in the course of normal operations. Expenses include staff payroll, program expenditures, property management costs and overhead.

When we record the transactions that reflect the operations of the business, the accounts are affected as indicated below. So, for example, to record an increase in cash — which is an asset — we record a *debit* to cash.

Debit Account to	Account Type	Credit Account to
Increase	Asset	Decrease
Decrease	Liability	Increase
Decrease	Revenue	Increase
Increase	Expense	Decrease

Financial Reports

When all transactions have been recorded for a particular period (a month, a quarter), the balances for each account are summarized into standard reports, such as the following:

Trial Balance is a listing of the chart of accounts with a balance for each account. This report shows that the books are in balance — debits equal credits.

Balance Sheet (or Statement of Financial Position) is a report of the financial position of the organization for a moment in time showing the assets, liabilities and net assets (difference between what is owned and what is owed).

Income Statement (or Statement of Activity) is a report of the financial performance of the organization for a period of time (month, year) showing the revenues, expenses and resulting difference (net income or loss).

Statement of Cash Flows is a report of cash activity for a period of time (in the past) showing the cash inflows and outflows from operations, financing and investing.

Statement of Functional Activities is a report showing a breakdown of expenses by functional area (such as development, management or administration) or by program (such as housing services or food bank).

Examples of these statements are found at the end of this section.

RESTRICTED FUNDS AND FUND ACCOUNTING

Many times in the nonprofit world, we are required to account for funds that are granted to us with restrictions on their use. These are called *restricted funds*. The opposite of this is *unrestricted funds*, which can be used for any purpose. The tracking and reporting of transactions by funding source is generally referred to as *fund accounting*. Money received from the federal government is almost always restricted and requires distinct reporting. In some cases it even requires separate bank accounts.

Think about:

- The number of different funding sources you have
- The source of your funding
- The intended use of each fund
- Whether the funds must be kept in a separate bank account
- Whether there is a time limit on spending the money
- What reporting is required by the donor
- When the required reporting is expected

ORGANIZE

Make a list of your current funding sources. For each fund, indicate the intended use, amount and reporting requirements. Include other information such as repayment requirements, if any. Update this list periodically to keep your perspective on the amount of restricted fund activity and its related accounting requirements. For example:

Donor	Purpose	Amount	Expires	Reporting	Due
HOME	Housing development	$50,000	12/31/00	HUD form	quarterly
NCDI	Operations	$35,000	06/30/00	Expense statement	quarterly
Bank	Operations (loan)	$80,000	09/30/00	Trial balance	biannually
Foundation	Job training program	$10,000	N/A	Income statement	monthly

ACCOUNTING SOFTWARE

Most accounting software is designed to record all of your financial transactions and to produce common reports, including financial statements and detailed journals and ledgers. In some cases, little accounting knowledge is required to run the software, but in most cases, the more a user understands about basic bookkeeping or accounting, the better he or she will understand the software's basic functions and additional options. Software decisions can be difficult, as there are many factors to consider and many options available.

Think about:

- The amount you can spend on accounting software over the next two years
- Who will run the accounting system and his or her level of experience
- The kind of computer equipment (hardware) you have or will have
- Transaction volume — the number of checks and deposits processed each month
- Internal (you, your staff, your board) and external (donors, government agencies) reporting needs
- Your need to track information by fund, program or project
- Whether you process payroll in-house or use a service
- Whether you need an internal property management system or an outside firm
- Whether you need to track rehab and construction costs separately by unit (Your general contractor may already be doing this for you.)
- Your business plan for growth over the next three to five years

For many small and start-up organizations with limited resources, it may be tempting to purchase one of the many inexpensive off-the-shelf packages. And while these may be adequate for simple operations, they tend to be very limited for even slightly complex organizations such as community development corporations (CDCs) or businesses that may grow quickly. You may want to refer to the Community Development Library's *Improving Your Accounting Software,* another manual in the *Money Management* series, for more detailed information.

A necessary companion to accounting software — or even to a manual accounting system — is a written accounting policies and procedures manual. A well-written manual will help the organization ensure consistency and accuracy in its financial operation, even in the face of staff turnover. Following those policies consistently should also make everyone's life easier at audit time.

Sample Journals

Nonprofit Property Management — Chart of Accounts

Account	Type	Account	Type
Cash — Checking	Asset	Management Fees	Expense
Cash — Security Deposits	Asset	Equipment Rental	Expense
Cash — Reserves	Asset	Marketing/Advertising	Expense
Accounts Receivable	Asset	Printing & Reproduction	Expense
Prepaid Expenses	Asset	Publications & Memberships	Expense
Land/Buildings	Asset	Dues & Fees	Expense
Accum. Depr. — Bldgs	Asset	Insurance	Expense
Rental Property Improvements	Asset	Repair & Maintenance	Expense
Accum. Depr. — Improvements	Asset	Grounds Maintenance	Expense
Office Furniture & Equipment	Asset	Water/Sewer	Expense
Accum. Depr. — Furn. & Equip.	Asset	Electricity	Expense
Long-Term Investments	Asset	Exterminating	Expense
Notes Receivable	Asset	Security	Expense
Accounts Payable	Liability	Landscaping	Expense
Payroll Liabilities	Liability	Laundry Expense	Expense
Tenant Security Deposits	Liability	Office Rent	Expense
Lease Payable	Liability	Office Utilities	Expense
Notes Payable	Liability	Telephone	Expense
Net Assets	Net Assets	Office Supplies	Expense
Grants (unrestricted)	Revenue	Postage & Delivery	Expense
Grants (restricted)	Revenue	Credit Fees	Expense
Contributions	Revenue	Fund-Raising & Event Costs	Expense
Fund-Raising Events Income	Revenue	Legal Fees	Expense
Rental Income	Revenue	Accounting & Auditing Fees	Expense
Interest Income	Revenue	Property Taxes	Expense
Salaries	Expense	Interest	Expense
Benefits	Expense	Depreciation	Expense
Payroll Taxes	Expense		

Cash Receipts Log

Date	Received from	Restrictions	Amount	(Debit) Deposited to	(Credit) Account
03/04/00	Foundation One	Rehab Constr.	30,000.00	Checking	Grants — Restricted
03/05/00	Moby Moneybags	None — private donation	2,000.00	Checking	Contributions
03/05/00	Safekey Insurance Company	None — refund of overpayment	150.00	Checking	Insurance Expense
03/07/00		Deposit to Checking	32,150.00		
03/12/00	West, Mae	N/A	300.00	Cash — Security Deposits	Security Deposits
03/14/00	East, June	N/A	425.00	Cash — Checking	Rental Income
03/20/00	City of Midtown	None — G&A	5,000.00	Cash — Checking	Grants — Unrestricted

Payment Records Log (Check Register)
Cash — Checking Account (Credit)

Date	Check/Ref	Paid To	Description	Amount	(Debit) Account
03/07/00	1056	Ace Supply Co.	Office Supplies	86.25	Office Supplies
03/07/00	1057	Bell East	Phone	146.43	Telephone Expense
03/07/00	1058	Hardhat Const. Co.	Rehab Costs — Main St. Project	8,784.55	Construction in Progress
03/07/00	1059	First Bank	Loan Payment	450.88	Notes Payable
03/07/00	1060	Mable Stable	Employee Loan	150.00	Accounts Receivable
03/07/00	1061	Computers R Us	Printer for Accounting	999.00	Furniture & Equipment
		Monthly check run total		10,617.11	

Payroll Register
For Payroll Period Ended: March 31, 2000

		Withholdings						
Employee	**Gross Wage**	**Federal**	**Soc. Sec.**	**Medicare**	**State**	**Health**	**Other**	**Net Pay**
Cross, Christopher	1,250.00	200.00	77.50	18.18	68.50	22.80		**863.02**
Novel, Rita	1,458.33	233.33	90.42	21.15	72.92	14.45		**1,026.06**
Reason, Wanda	1,041.67	166.67	64.58	15.10	58.08	22.80		**714.44**
Stable, Mable	833.33	133.33	51.67	12.08	41.67	14.45	repay advance 10.00	**570.13**
Zipper, Jonathan	240.00	38.40	14.88	3.48	12.00			**171.24**
Totals	**4,823.33**	**771.73**	**299.05**	**69.99**	**253.17**	**74.50**	**10.00**	**3,344.89**

General Ledger

Ref	Date	Accounts/Description	Debit	Credit
JE 0022	3/06/00	Cash — Savings Cash — Checking Transfer funds from checking to savings	4,000.00	 4,000.00
JE 0023	3/15/00	Prepaid Expense Insurance Expense To adjust insurance expense for quarterly premium paid in January	230.00	 230.00
JE 0024	3/30/00	Depreciation Expense Accum. Depr. — Furn. & Equip. To record monthly depreciation	285.50	 285.50
JE 0025	3/30/00	Interest Expense Interest on Notes Payable To accrue interest on working capital loan	122.75	 122.75
JE 0026	3/30/00	Cash — Savings Bank Fees Expense Cash — Checking Interest Income To record interest & bank fees per March bank statement	46.77 15.00	 15.00 46.77

Sample Financial Reports

Your Neighborhood CDC trial balance — March 31, 2000

Account	Debit	Credit
Cash — Checking	$ 10,650	
Cash — Savings	56,900	
Cash — Petty Cash	250	
Accounts Receivable	1,230	
Prepaid Expenses	900	
Land/Buildings	86,700	
Construction in Progress	313,345	
Office Furniture & Equipment	12,580	
Accumulated Depreciation — Furn.& Equip.		$ 5,870
Notes Receivable	18,500	
Accounts Payable		7,085
Payroll Liabilities		1,965
Purchaser's Deposits		2,405
Notes Payable		58,700
Net Assets		452,710
Grants (unrestricted)		17,530
Grants (restricted)		21,890
Contributions		11,750
Fund-Raising Events Income		0
Program Fees		1,405
Proceeds from Sale of Property		3,600
Interest Income		1,135
Salaries	55,590	
Benefits	4,950	
Payroll Taxes	4,985	
Program Supplies & Expenses	1,025	
Development Expenses	650	
Equipment Rental	450	
Staff Training	1,250	
Marketing/Advertising	485	
Printing & Reproduction	450	
Publications & Memberships	285	
Dues & Fees	330	
Conferences & Seminars	895	
Travel	240	
Fund-Raising & Event Costs	75	
Rent	1,600	
Utilities	245	
Telephone	2,215	
Repair & Maintenance	85	
Insurance	1,560	
Office Supplies	935	
Postage & Delivery	1,025	
Legal Fees	400	
Accounting & Auditing Fees	3,765	
Interest	300	
Depreciation	1,200	
	$586,045	$586,045

Your Neighborhood CDC balance sheet — March 31, 2000

ASSETS	CURRENT ASSETS	
	Cash — Checking	$ 10,650
	Cash — Savings	56,900
	Cash — Petty Cash	250
	Accounts Receivable	1,230
	Prepaid Expenses	900
	Total Current Assets	**69,930**
	HOUSING INVENTORY	
	Land/Buildings	86,700
	Construction in Progress	313,345
	Total Housing Inventory	**400,045**
	FIXED ASSETS	
	Office Furniture & Equipment	12,580
	Accum. Depr. — Furn. & Equip.	(5,870)
	Total Fixed Assets	**6,710**
	OTHER ASSETS	
	Notes Receivable	18,500
	Total Other Assets	**18,500**
	TOTAL ASSETS	**$ 495,185**
LIABILITIES		
	CURRENT LIABILITIES	
	Accounts Payable	$ 7,085
	Payroll Liabilities	1,965
	Purchaser's Deposits	2,405
	Total Current Liabilities	**11,455**
	LONG-TERM LIABILITIES	
	Notes Payable	58,700
	Total Long-Term Liabilities	**58,700**
	TOTAL LIABILITIES	**70,155**
	NET ASSETS	**425,030**
	TOTAL LIABILITIES & NET ASSETS	**$ 495,185**

Your Neighborhood CDC income statement —
Year-to-date: March 31, 2000

REVENUES	Grants (unrestricted)	$ 17,530
	Grants (restricted)	21,890
	Contributions	11,750
	Fund-Raising Events Income	0
	Program Fees	1,405
	Proceeds from Sale of Property	3,600
	Interest Income	1,135
	Total Revenues	**57,310**
EXPENSES	Salaries	55,590
	Benefits	4,950
	Payroll Taxes	4,985
	Program Supplies & Expenses	1,025
	Development Expenses	650
	Equipment Rental	450
	Staff Training	1,250
	Marketing/Advertising	485
	Printing & Reproduction	450
	Publications & Memberships	285
	Dues & Fees	330
	Conference Seminars	895
	Travel	240
	Fund-Raising & Events Costs	75
	Rent	1,600
	Utilities	245
	Telephone	2,215
	Repair & Maintenance	85
	Insurance	1,560
	Office Supplies	935
	Postage & Delivery	1,025
	Legal Fees	400
	Accounting & Auditing Fees	3,765
	Interest	300
	Depreciation	1,200
	Total Expenses	**84,990**
	NET SURPLUS/DEFICIT	**$ (27,680)**

Your Neighborhood CDC statement of cash flows —
Year-to-date: March 31, 2000

Cash flows from operating activities		
INFLOWS		
Unrestricted Revenue	$29,280	
Restricted Revenue	21,890	
Program Fees	1,405	
Proceeds from Sale of Property	3,600	
Interest Income	1,135	
Total Inflow from Operations		**$ 57,310**
OUTFLOWS		
Personnel Expenses	$61,790	
Program & Development Expenses	1,675	
General & Administration Expenses	12,925	
Total Outflow from Operations		**$ 76,390**
TOTAL CASH FLOWS FROM OPERATING ACTIVITIES		**$ (19,080)**
Cash flows from investing activities		
INFLOWS		
Principal payments on loans to affiliates	$3,000	
OUTFLOWS		
Purchase of computer equipment	$999	
TOTAL CASH FLOWS FROM INVESTING ACTIVITIES		**$ 2,001**
Cash flows from financing activities		
INFLOWS		
Working capital loan from bank	$10,000	
OUTFLOWS		
Principal payments on notes payable	$ 2,600	
TOTAL CASH FLOWS FROM FINANCING ACTIVITIES		**$ 7,400**
NET CASH FLOW		**$ (9,679)**
BEGINNING CASH, JAN. 1, 2000		**$ 77,479**
ENDING CASH, MARCH 31, 2000		**$ 67,800**

Your Neighborhood CDC statement of functional activities —
Year-to-date: March 31, 2000

	Development	Program	G&A	Totals
Salaries	$19,457	$13,897	$22,236	$55,590
Benefits	1,733	1,237	1,980	4,950
Payroll Taxes	1,745	1,246	1,994	4,985
Program Supplies & Expenses		1,025		1,025
Development Expenses	650			650
Equipment Rental		450		450
Staff Training	438	312	500	1,250
Marketing/Advertising	400	85		485
Printing & Reproduction	375	75		450
Publications & Memberships			285	285
Dues & Fees	330			330
Conferences & Seminars		750	145	895
Travel	150	40	50	240
Fund-Raising & Event Costs			75	75
Rent			1,600	1,600
Utilities			245	245
Telephone	775	554	886	2,215
Repair & Maintenance			85	85
Insurance			1,560	1,560
Office Supplies	85	600	250	935
Postage & Delivery	275	550	200	1,025
Legal Fees			400	400
Accounting & Auditing Fees			3,765	3,765
Interest			300	300
Depreciation			1,200	1,200
	$26,413	**$20,821**	**$37,756**	**$84,990**

Internal Controls

The most important element of good financial management is a strong internal control structure. Internal control is generally defined as the policies and procedures established to ensure that an organization's objectives can be achieved. With respect to financial management, this includes the safeguarding of assets; accurate and reliable record keeping; compliance with internal policies and funding requirements; and the separation of duties. Some examples of a good internal control structure include:

- The person responsible for making deposits and writing checks does not also perform the bank reconciliation (separation of duties).
- The person writing the checks is not authorized to sign them as sole signatory (separation of duties).
- Office equipment and furniture are inventoried with supporting documents (safeguarding of assets).
- Employees handling cash are bonded (safeguarding of assets).
- A competent internal staff member or outside service is responsible for recording transactions (record keeping).
- A central filing system for supporting financial documents — invoices, deposits, loan agreements — is used (record keeping).
- A written accounting policies and procedures manual (compliance) exists.
- Required Internal Revenue Service (IRS) forms or other financial reports are filed on a timely basis (compliance).

Beyond providing assurance of the accuracy and reliability of your record keeping, good financial management ensures that your financial records are complete. The key to achieving this goal is *organization*. Whether using manual procedures or automated accounting software, you want to have in place a dependable record-keeping *system*. Your system should consist of clear policies that describe how transactions are handled (authorized and recorded), how information moves through the organization and where information is stored. For example, "After an invoice is paid, a copy of the signed check is attached to the invoice and filed with the other paid bills."

Lastly, producing routine financial statements and their subsequent review by management are critical elements of good financial management. Some examples of these statements include statements of actual expenses against approved budgets, cash flow and current cash position statements, balance sheets, revenue and expense statements, and project accounting statements showing costs to date.

HOW DO YOU KNOW WHEN YOU NEED HELP?

Is your house in order? Does your organization incorporate the elements of good financial management? Do you need assistance with the bookkeeping and accounting functions?

Often these questions are answered by a donor's requirement that the organization have an annual or periodic audit. Spending over $300,000 in federal funds a year, for example, requires that a single audit be conducted. A single audit is the term for an audit that includes the examination of financial statements and tests of compliance with respect to federal awards (financial audit + A-133 audit). See *Understanding the Federal Rules for Nonprofit Fiscal Management* in the *Money Management* series for more information.

In preparing for an audit, an organization needs to gather all its financial information, as well as all supporting documentation and evidence. It may require a substantial effort to organize, record and summarize all of your business activities. Naturally, it is a good idea to incorporate these practices into the general operations of your business. If you answer no (or cannot quickly find out the answer) to more than one of the following questions, you probably need help with your books.

- Do you know how much cash you have in the bank?
- Do you know if you are close to running out of unrestricted money? Or restricted?
- Was your checking account reconciled last month?
- Do you know what your year-to-date program costs are?
- Do you have an operating budget for the current year?
- Do you know whether or not you need an audit? An A-133 audit?
- Do you maintain copies and backups of your bank deposits?
- Are your paid bills filed in a central location?
- Do you know how much is currently outstanding in accounts payable? (Do you know what *accounts payable* means?)
- Do you know how much revenue you can expect to receive in the next two months?

Tax-Exempt Status

Under the IRS tax code, a 501(c)(3) organization is defined as a charitable, religious, educational, scientific or other nonprofit organization. A 501(c)(3) organization enjoys tax-exempt status. To qualify for this status, the organization must file an application for recognition of exemption (IRS Form 1023) that states the charitable purpose, intended activities and funding sources of the organization. Determination is based on evidence that funds are dedicated to the purposes listed in section 501(c)(3) of the code. In addition, the determination requires that:

- No part of the net earnings benefits any private *shareholder* or individual.
- No substantial part of the operating activities attempts to influence legislation.
- The organization does not participate in political campaigns on behalf of any candidate for public office.
- No funds distributed to other organizations not exempt under 501(c)(3) deviate from the required purposes of the disbursing organization.

Some lobbying, relevant to the purpose of the organization, may be allowed under code section 501(h). To determine your "ceiling" on these activities, consult with your certified public accountant (CPA) or tax advisor.

Organizations qualifying for 501(c)(3) status fall into one of two main classifications: public charities and private foundations. All organizations are classified as private foundations unless they fit into one of the five categories of private charities:

1. Public institutions (schools, hospitals, churches)
2. Publicly supported organizations (based on contributions)
3. Publicly supported organizations (based on earned income)
4. Supporting organizations
5. Organizations with a primary mission of testing for public safety

FORM 990

501(c)(3) organizations with gross receipts in excess of $25,000 are required to file an annual return with the IRS — Form 990. The information contained on the form includes:

- Financial information on the nonprofit's revenues, expenses and fund balances
- Financial information on the expenses for each program or functional activity
- Statement of the accomplishments of the organization's program services
- Balance sheet
- Lists of officers, directors, trustees and key employees
- Other information verifying continued 501(c)(3) status
- Analysis of income-producing activities

Organizations described in section 501(c)(3) as nonexempt charitable trusts (nonprivate foundations) are also required to file Schedule A of Form 990, which asks for additional information about the nonprofit's program activities, lobbying efforts and the reasons for its nonprivate foundation status. Additional supporting financial information is also required on Schedule A.

UNRELATED BUSINESS INCOME

Unrelated business income is defined as any gross income generated from activities that are regularly carried on by an exempt organization and not substantially related to the organization's exempt purpose. That is, "the activity that produces income does not contribute importantly to the exempt purposes of the organization other than the need for funds." Unrelated business income is not exempt from taxation. IRS Form 990-T is filed by exempt organizations to report their unrelated business income and figure their unrelated business income tax (also known as UBIT).

Some deductions from the gross unrelated business income are allowable in the computation of the income tax as long as they are not deductions taken elsewhere and they are directly connected with the unrelated business income.

An example of unrelated business income might be:

A company resource center that provides job training to low-income people hosts a bingo night and bake sale every Wednesday evening. The income is used to fund the overall operations of the resource center; however, gambling and selling cakes are *not* considered activities *substantially related* to the organization's exempt status. Note that the activity is *regularly carried on* — every Wednesday.

An organization that has a large portion of its gross income coming from unrelated business income may jeopardize its tax-exempt status. When examining the organization's income and activities, the IRS could conclude that:

- The organization's unrelated activities, rather than its exempt purpose, are the organization's primary concern or purpose.
- The organization is engaging principally in the conduct of a commercial activity or trade or business for profit.
- Its charitable activities are of relatively minimal consequence.

Such a conclusion could lead to a denial or revocation of tax-exempt status.

Because there are few clear-cut guidelines on how much unrelated business activity is too much, an organization that finds itself with a substantial amount of unrelated business income should ask: Has our profit motive or unrelated activities transcended or surpassed our exempt purpose? If the answer could be "yes," the organization should re-examine the type and level of its unrelated business activity and adjust its overall activities to be more in line with its exempt purpose.

Determining Your Accounting Service Needs

What is the difference between a bookkeeper and an accountant? How do you determine what your organization needs in the way of financial management services? How do you select or staff those services? And how does the auditor fit into all of this? Do you need a CPA? The following information may help you answer these questions.

BOOKKEEPER

The bookkeeper's function is to record all the financial transactions of the organization into journals and ledgers. These records constitute *the books* and should detail all of the business activities in a logical order (chronologically) for a certain period of time (monthly). It is from these books that the financial information is summarized into financial statements such as the balance sheet and the income statement. Many times accounting software facilitates the recording of transactions and the producing of financial statements.

Usually, the bookkeeper is responsible for disseminating the source documents that support each transaction: deposit slips, invoices, check requests, time sheets, etc. These documents are the basis from which *entries* are made in the records. The role of the bookkeeper may include writing checks, generating the payroll and reconciling the bank accounts. The degree to which these duties are handled by one person depends on the size of the organization and the appropriate level of internal controls. Generally, one person should not have sole responsibility for making deposits, signing checks and reconciling the bank statement.

In today's job market, a bookkeeper's qualifications usually include one to two years of college-level accounting coursework, although it is not unusual to find someone who has, through some years of clerical experience, learned the basic skills of bookkeeping on the job. When considering someone for the bookkeeping function, an employer should look for a candidate who understands *debits and credits*. These are fundamental concepts that underlie the proper treatment of transactions. And although these concepts are universal in the business world, an employer may want to look for someone who has knowledge or experience in a particular industry. This is not always necessary, considering that the bookkeeper position is often an entry-level position or supplemental to other clerical duties such as office management or secretarial.

ACCOUNTANT

An accountant takes a bookkeeper's skills and responsibilities a step further. Either staff or a contracted service provider, the accountant will take the financial records and compile them into financial statements and possibly offer interpretations on the financial position or performance of the organization. Sometimes the functions of bookkeeper and accountant are combined. Sometimes the accountant is a CPA.

Typically in the accounting field, the distinction between accountants and bookkeepers is one of education and experience. An accountant usually has at least an associate or, in most cases, a bachelor's degree in accounting. The accountant is often better skilled and educated in the proper treatment of transactions and how they affect the financial reports. More so than a bookkeeper, an accountant may act as a business advisor. Some accountants are also uniquely skilled in addressing and interpreting tax-related issues — a specialty within the field — and most accountants will, at the very least, complete the organization's tax returns.

The accounting field can be further specialized by industry. When considering a staff accountant or outside service, look for someone who understands your business. While the basic concepts of accounting are universal, there are distinct rules and standards for certain industries. An accountant for manufacturing may possess a different set of skills than an accountant for nonprofit organizations.

AUDITOR

Your accountant may also be your auditor. Arguably, auditing and tax services constitute the primary functions of the accounting field. An audit is an examination of an organization's financial statements consisting of a searching investigation of the accounting records and other evidence to support those financial statements. The role of the auditor is to *attest* or provide assurance to the fairness and credibility of the financial statements. The final result of any audit is the issuance of an audit report whereby the auditor expresses an opinion on the client's financial statements.

> *Consider industry focus when looking for an auditor. Meet with prospective auditors to determine if they are familiar with your operations and issues.*

With any luck, your auditor will issue an unqualified report, which states that your financial statements do indeed "present fairly the financial position and results of operations" for your organization for the stated period. It is important to note that an audit report expresses an opinion on the financial statements, not on the accounting records. The client is primarily responsible for all records and statements. *Assessing Your Organization's Finances*, another manual in the *Money Management* series, includes more details on audit reports and opinion letters.

Most auditors work for CPA firms. A CPA is a professional who has passed a national exam. Some states have additional requirements for certification such as a certain number of hours of auditing experience. While not every auditor working with you may be certified, the managing partner who signs the audit report should be a CPA.

Consider industry focus when looking for an auditor. CPA firms typically specialize in certain fields. Again, you want an auditor who understands your business and the related audit and tax issues. Check with similar organizations in your region to see who they use for auditing services. Meet with prospective auditors to determine if they are familiar with your operations and issues. For example, you may need a professional who knows federal compliance and is up-to-date on the latest nonprofit reporting standards (FASB 116 & 117).

The process for contracting with an auditor or CPA firm begins with a proposal. The prospective firm will outline the auditing services, including time and cost estimates. Audit professionals bill by the hour using a rate scheduled based on staff level: A staff auditor bills at a lower rate than a managing partner. Once a proposal is accepted, the auditing firm will furnish an *engagement letter* which summarizes the nature of the work to be performed. The acceptance of this letter represents an *executory contract* and should be signed by the client and CPA.

OTHER CPA SERVICES

Two other services that CPAs can provide are compilations and reviews. A compilation is the preparation of financial statements from the accounting records of the client. This is the activity described in the section above about the services of an accountant. The compilation itself does not include any investigation of the books. Yet it can often precede an audit and be part of the audit engagement. This is usually the case with very small organizations that have no internal accounting function.

A review is similar to an audit but not as extensive in its scope. The procedures of a review are generally limited to 1) obtaining an understanding of the preparation of financial information, 2) applying analytical procedures to the financial data and 3) making inquiries of the persons responsible for financial matters. A review involves a report, much like an audit report, that states that the auditors are not aware of any *material modifications* necessary to bring the financial statements into conformity with generally accepted accounting principles. The language in the review report is different from an audit report in that the CPA does not express an opinion on the fairness of the financial statements.

CPA firms typically offer additional services to clients such as business advisory or information systems consulting. While these services generally require separate engagement contracts, many issues related to internal control and financial management can be raised in the course of the audit. This is because the scope of an audit requires CPAs to consider the internal control structure of the organization. If, during the audit, a deficiency in internal control is uncovered, the auditor is responsible for communicating this *reportable condition* to the client. A reportable condition is defined as "a significant deficiency in the design or functioning of the internal control that could adversely affect the organization's ability to record, process, summarize and report financial data."

At the completion of the audit, the CPA usually presents any reportable conditions or other issues in a *management letter* to the client. Unlike the audit report, the management letter is for management only and is not typically made public (unless through litigation). It is then the responsibility of the client to address the issues and conditions raised in the management letter, preferably before the next audit. A sample management letter follows.

Sample Management Letter

Smith & Associates
Certified Public Accountants
540 Main Street
Boston, MA 02116

August 10, 2000

Board of Directors
ABC Community Development Corporation
15 Grant Avenue
Boston, MA 02215

Distinguished Members of the Board:

In planning and performing our audit of the financial statements of ABC Community Development Corporation (CDC) for the fiscal year ended June 30, 2000, we examined CDC's internal control structure to determine our auditing procedures for the purpose of expressing an opinion on the financial statements, not to provide assurance on the internal control structure.

However, we noted a matter involving the internal control structure and its operation that we consider to be a reportable condition under standards established by the AICPA. Our audit revealed that no one on the board reviews the bank reconciliation. Since the executive director performs the majority of the financial duties, the board should appoint a member to periodically review the bank reconciliation, initializing and dating the reconciliation to indicate the review.

These comments have been discussed with the executive director, and the status of this condition will be reviewed during our next audit engagement. This report is intended solely for the information and use of the board of directors, management and others in the organization.

Sincerely,

Don Smith

Don Smith, CPA

Notes

Notes

THE ENTERPRISE FOUNDATION

The Foundation's mission is to see that all low-income people in the United States have access to fit and affordable housing and an opportunity to move out of poverty and into the mainstream of American life. To achieve that mission, we strive to:

- Build a national community revitalization movement.
- Demonstrate what is possible in low-income communities.
- Communicate and advocate what works in community development.

As the nation's leader in community development, Enterprise cultivates, collects and disseminates expertise and resources to help communities across America successfully improve the quality of life for low-income people.

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Authors: David Crowley, CPA and consultant; LaCharla Figgs, The Enterprise Foundation
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