

CHAPTER 1

Budgeting and Financial Operation

Important Terminology and Standards

TO PREPARE A BUDGET THAT IS REASONABLE, accurate, and understandable, a working knowledge of terminology and accounting standards is vital. The following list briefly explains this terminology accordingly.

Terminology

501(c)(3) Organizations

These kinds of not-for-profit organizations are typically organized for charitable, educational, scientific, or religious purposes.

Advantages:

- Charitable contributions are deductible on the tax returns of the donors
- Grant eligibility
- Favorable postal rates
- Exemption from Federal Unemployment Tax
- Employees can participate in 403(b) plans
- Often benefit from state programs such as exemption from sales taxes

Disadvantages:

- Severe restrictions regarding lobbying
- Lobbying for legislation must be “unsubstantial,” while lobbying regarding elections is prohibited

501(c)(6) Organizations

501(c)(6) organizations are typically organized for business purposes such as chambers of commerce and trade associations.

Advantages:

- Unlimited lobbying

Disadvantages:

- Contributions are not tax deductible
- Lack of grant eligibility
- Full postage rates
- Not exempted from federal unemployment tax
- Employees cannot participate in 403(b) plans
- Generally don't benefit from state programs

Accounting Periods

Accounting periods for not-for-profit organizations include:

- *Calendar year.* When a not-for-profit organizations year begins on January 1 and ends on December 31.

Fiscal year. Not-for-profit organizations that are not on a calendar year when their accounting year does not begin on January 1st and does not end on December 31st.

- *Short period.* A not-for-profit organization uses this accounting period because it started later than January 1 and changes its accounting year or terminates.

In the case of an accounting period change, the not-for-profit organization must file Form 3115.

Accounts Receivable

Monies owed to the organization are treated as an asset on the Statement of Financial Position. Most auditors feel that outstanding dues should not be accorded Accounts Receivable status as the dues outstanding rarely are *legally* binding. Most auditing CPAs feel that, unless there is a legal obligation to pay, the amounts should not be listed with Accounts Receivable.

Accounts Payable

Monies owed by the organization to other entities should be classified as Accounts Payable; that is, assuming the organization has a legal obligation to pay.

Accumulated Depreciation

The journal entries crediting Accumulated Depreciation are cumulative, and over time the cost of the asset less Accumulated Depreciation will result in a book value equaling scrap value or zero.

American Institute of Certified Public Accountants (AICPA)

The AICPA is a professional association whose members are mainly CPAs.

Amortization

Amortization is similar to depreciation but typically applies to leasehold improvements or reduction of value of goodwill expenditures, such as copyrights purchased and the like.

Typically leasehold improvements are amortized over the remaining time left in the lease and nonfinancial assets are amortized over the shelf-life of the asset.

Board-Designated Funds

There is a lot of confusion concerning such accounts. While the Board of Directors can allocate the use of funds for a specific purpose, these funds are subject to creditor action. However, most accountants agree that properly recorded restricted funds are protected. A term that should be avoided is a Board *restricted* fund because it implies the asset was contributed. Also, generally stated, the organization is usually powerless to remove the restriction(s) from a restricted transaction.

Building and Land

When an organization purchases real property, a distinction of the value of the building and the land should be computed. The value of the building is capitalized as well as the value of the land. Only the value of the building will be depreciated (typically over 30 years) and the value of the land will not be depreciated, the theory being that the land will always exist.

It is also important to note that the building must be presented at its historical cost (plus improvements) on the Statement of Financial Position, even if it is *increasing* in value.

Capitalization

Capitalization is treating a cash outlay as creating or increasing the value of an asset on the Statement of Financial Position rather than classifying the cash outlay as an expense on the Statement of Activity.

Every not-for-profit organization should have a policy whereby purchases of items greater than the capitalization cut-off amount are capitalized and depreciated.

Capitalization Cut-Off Point

This is the dollar amount under which a cash outlay will be treated as an expense and over which it will be treated as creating or enhancing the value of an asset.

Certified Public Accountant (CPA)

A designation granted to individuals who have met the education requirements, passed the CPA examination, and have followed the continuing education credits requirements.

Conflict of Interest Policy

A not-for-profit organization filing Form 990 is required to have a Conflict of Interest Policy. A Conflict of Interest Policy must be imposed on officers, directors, and managers who are in a position to benefit financially due to a decision. See also *Disqualified Person* and *Intermediate Sanctions*.

Convention Cancellation Insurance

It is very common for not-for-profit organizations to have a substantial financial interest relating to their convention, festivals, and the like. If this is the case, contact your insurance agent and request a Convention Cancellation Insurance application. Typically this insurance will make the organization whole in the event that a labor strike, act of God, and the like affects the organization's meeting.

Credits

A credit increases liabilities and decreases assets on the Statement of Financial Position.

A credit increases revenues and decreases expenses on the Statement of Activity.

Debits

A debit increases the value of assets and decreases liabilities on the Statement of Financial Position.

A debit increases expenses and reduces revenues on the Statement of Activity.

Deferred Compensation

Deferred compensation is compensation that has been earned or accrued that is deferred to a later year.

Deferred Income

Deferred income is a liability account on the Statement of Financial Position. It includes monies that the organization receives for which it owes a future service. After the service has been provided, the amount will be taken out of deferred income

and reclassified as a revenue on the Statement of Activity. Common examples include dues and deposits received for exhibit booth deposits in advance.

Note: On first exposure, it may appear that amounts classified as deferred income should be treated as an asset rather than a liability. However, the future cannot be predicted and there is no guarantee that the event will take place. For example, what if a fire resulted in canceling the event? Generally, the deposits from exhibitors would have to be refunded, and that is why it is treated as a liability.

Depreciation

Reducing the value of an asset over time and according to established policy.

For example, “an organization might utilize the Straight Line Method over the following time periods:

Buildings	30 years
Furniture	10 years
Electronic Equip.	3 years

Typically depreciation is accounted for by a journal entry as follows:

Debit	Depreciation Expense
Credit	Accumulated Depreciation

Please note that this is a hypothetical scenario.

Direct Expenses

Direct expense are expenses that can be allocated to a specific activity or project.

For example, the purchase of a single computer that will be specifically used by one activity or project would be a direct expense.

Disclosure of Information Policies

This is a not-for-profit organization’s policy on what federal and state forms are open for inspection by the general public, members, or contributors.

Disqualified Person

A disqualified person is any person in a position to exercise substantial influence over the affairs of the not-for-profit organization. See also *Intermediate Sanctions*.

Dues

There is a disagreement among accountants whether or not uncollected dues qualify as accounts receivable, as there is rarely a legal obligation for the member to pay. It has been the author’s experience that recording outstanding dues as accounts receivable

is the most common reason not-for-profit organizations experience financial difficulties. It is the author's suggestion not to classify outstanding dues among legitimate accounts receivable but rather detail this amount on the Executive Summary.

Excess Benefit Transactions

See *Disqualified Person* and *Intermediate Sanctions*.

Executive Summary

An Executive Summary is a written explanation accompanying the internal financial statements that explains items in the statements that a reader could not pull out of the numbers. For example, consider a dollar amount for rent in the financial statements. This may be explained in the Executive Summary as to how much square feet is leased, the current rent per square feet, lease escalation clauses, and maturity date.

Form 990

Form 990 is an information IRS filing. It is open to *public inspection*.

Form 990-EZ

Form 990-EZ is a *shortened* version of the Form 990 that is suitable for smaller not-for-profit-organizations. It is also open to *public inspection*.

Form 990-N

Form 990-N is an *electronic* information IRS filing for very small not-for-profit organizations that do not regularly have gross receipts over \$25,000.

Form 990-PF

Form 990-PF is an information return filed by private foundations.

Form 990 Schedules

There are 16 possible schedules (Schedules A thru O) that may be required to file Form 990. However, only Schedules A, B, C, E, G, L, and N apply to Form 990-EZ.

Form 990-T

This is required to report an unrelated business income tax (UBIT) that must be filed if the not-for-profit organization has \$1,000 or more from an unrelated source, even if it resulted in a loss.

Form 5500

Form 5500 is an Annual Return/Report of Employee Benefit Plan. An organization's pension, deferred compensation, or profit sharing must be listed.

Foundations

Typically a 501(c)(3) organization formed by a 501(c)(6) organization to be eligible for contribution deductibility, grant eligibility, and the like. See also *501(c)(3)*, advantages and disadvantages.

Functional Accounting

When certain revenues and expenses are credited to or charged by policy to various departments, functions, or units, the resulting statements are based on functional accounting. Most not-for-profit organizations have numerous functions. For reporting purposes, the organization must have two functions: administration and program services. (Program services are the total of all departments with the exception of administration.)

Finally, many not-for-profit organizations that are involved in raising funds must have a third function entitled "Fund Raising."

Fund-Raising Activities

Fund-raising activities are activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, or other assets or time.

Fund-raising activities are required to be accounted for and listed on Form 990. Fund-raising expenses do not include program service expenses or management/general expenses.

Generally Accepted Accounting Principles (GAAP)

GAAP are accounting principles promulgated by the Financial Accounting Standards Board (FASB) and the AICPA that guide the work of auditing CPAs.

Generally Accepted Auditing Standards (GAAS)

GAAS are rules that auditing CPAs must follow when auditing an organization.

Group Returns

A central, parent, or similar not-for-profit organization can file a group return for two or more subordinate organizations that are:

1. Affiliated with the central organization
2. Subject to the central organization's supervision or control
3. Included in a Group Exemption Letter that is still in effect
4. Using the same accounting period as the central organization

High-Compensation Employees

High-compensation employees are those who earn \$100,000 or more per year. Typically, they are the top five employees listed on Form 990.

Independent Contractors

An independent contractor is a person who is compensated by the not-for-profit organization but who is not an employee and for whom payroll taxes are withheld. As of this writing, if an individual is paid \$600 or more, a Form 1099 must be issued.

The top five independent contractors making \$100,000 or higher must be reported on Form 990 and include the following:

1. Professional fund raisers
2. Law and accounting firms
3. Publishing companies
4. Management companies
5. Investment companies

Indirect Expenses

These are expenses that are allocated to organization activities or projects that are shared by other activities or projects.

For example, purchase of computer software that is used by more than one activity or project would be an indirect expense.

Intermediate Sanctions

Intermediate sanctions apply if a disqualified person receives unreasonable benefits, also called "private enurement," due to their position of influence. If a disqualified person receives an excessive benefit, the excessive benefit must be returned to the organization and a penalty of up to 25 percent of the excessive benefit may be imposed.

IRS Web Site

Any person can go directly to the IRS web site to download forms, schedules, and instructions, which is at www.irs.ustreas.gov/.

Journal Entry

A journal entry is an accounting transaction not triggered by making a deposit or writing a check. Common transactions requiring journal entries include bank service fees, depreciation, amortization, and the like.

Key Employee

Responsibility Tests:

1. The employee has responsibilities, powers, or influence over the organization similar to officers, directors, or trustees.

2. Manages a segment of the organization of 10 percent or more of the organization's activities, assets, income or expenses.

Note: key employee's compensation is reported on Form 990 if the employee's compensation is \$150,000 or more.

Leasehold Improvements

When an organization expends money to improve property over the capitalization cut-off point that they *do not own*, the outlay—the leasehold improvement—will be capitalized and classified as an asset on the Statement of Financial Position.

The reason behind this is that improvements of non-owned property stay with the property after the lease expires. Common examples are wall-to-wall carpeting, electrical improvements, and the like.

Long-Range Plan

A long-range plan is a budget that is prepared five or more *years* in advance.

Management/General Expenses

These are expenses that affect more than one activity and must be accounted for separately and listed on Form 990. Management/general expenses do not include program service expenses or fund-raising expenses.

Mission Statement

A not-for-profit organization filing Form 990 should have a mission statement that is included on Form 990 and communicated to officers, directors, managers, key employees, and the like.

Ogden, UT

The IRS service center, located in Ogden, Utah, is where forms 990, 990-EZ, and 990-N are filed for domestic not-for-profit organizations.

Optional Proxy Tax

The optional proxy tax is a tax imposed on not-for-profit organizations that spend greater than \$2,000 on lobbying. The tax is recorded on Form 990-T.

Permanently Restricted Net Assets

This account is used if an organization receives a contribution that has been permanently restricted by the donor, meaning that the organization cannot use these funds and they hold the contribution in perpetuity. The use of the earnings of a permanently restricted net asset is *dictated by the donor*. The earnings may be unrestricted or temporarily restricted. It is prudent not to commingle a permanently restricted net

asset cash with unrestricted cash and these assets should be shown in proximity with fixed assets on the Statement of Financial Position. Permanently restricted net assets are usually cash, equity securities, debt securities, or real estate.

Prepaid Expenses

Prepaid expenses are monies that the organization expended for which it will receive a future benefit and treated as an asset on the Statement of Financial Position. A common example is a deposit made to a hotel for an event to be held in the future. After the event is concluded, this amount is taken out of the prepaid expense asset account and reclassified as hotel expense in the Statement of Activity.

Private Enurement

See *Disqualified Person* and *Intermediate Sanctions*.

Program Service Expenses

These are expenses directly involved in benefitting members, contributors, and the like. Program service expenses must be accounted for separately and are recorded separately on Form 990. Program services expenses do not include fund-raising or management/general expenses.

Records Retention and Destruction Policy

A not-for-profit organization filing Form 990 is required to research federal, state, and local regulations affecting how long records must be kept before destroying. A log should be maintained when records are disposed.

Statement of Activity

As part of Statement of Financial Accounting Standards No. 117, the terminology for many statements has been changed. The Statement of Activity is the new term for the Income Statement or Profit and Loss Statement.

Statement of Financial Position

As a part of Statement of Financial Accounting Standards No. 117, the terminology for many statements has been changed. The Statement of Financial Position is the new terminology for the Balance Sheet.

Temporarily Restricted Net Assets

This account is used if an organization receives contributions for a specific purpose that will eventually be spent. A common temporarily restricted contribution is a contribution to a scholarship fund.

As in the case of permanently restricted net assets, it is prudent not to commingle temporarily restricted cash with unrestricted cash.

Unrestricted Net Assets

Unrestricted net assets are comparable to the retained earnings of a commercial organization in that it is the cumulative profit or loss since the organization was formed.

This account is also the book value net worth of the organization and has almost nothing to do with available unrestricted cash.

Whistle Blowers Protection Policy

A not-for-profit organization filing Form 990 is required to have a Whistle Blower Protection Policy, which prevents retaliation to employees reporting illegal actions, unethical actions, and the like.

Wholly Owned Taxable Subsidiaries

Generally, a wholly owned taxable subsidiary is a stock corporation owned by the not-for-profit organization and formed to reduce unrelated business income tax or to protect tax-exempt status.

Zero-Based Budgeting

This term is commonly used, but rarely are zero-based budgeting principles applied.

The essence of zero-based budgeting is that prior transactions are *not* referred to when compiling a new budget. The vast majority of not-for-profit organizations have expenditures that *will* continue into a subsequent year and prior history must be referred to. Examples include member newsletters, magazines, insurance, program services, and the like.

Auditing and Financial Standards

Statement of Auditing Standard No. 99 (SAS 99)

SAS 99 directs auditing CPAs on how to consider fraud in a Financial Statement Audit.

Highlights:

- Requires audit team to have a brainstorming among audit team members before the audit commences
- Requires a better understanding of the client's business
- Requires inquiries of key personnel
- Requires analytical procedures based on professional skepticism
- Requires documentation of information gathering

Note: For a detailed explanation of this statement, review *Preventing Fraud in Not-For-Profit Organizations*, published by John Wiley & Sons.

Statement of Financial Accounting Standards No. 116 (SFAS 116)

SFAS 116 directs auditing CPA on how the accounting for contributions received and made are to be handled.

Highlights:

- When and how to recognize contributions in the financial statements
- Rules on classifying contributions are unrestricted, temporarily restricted, and permanently restricted
- Rules for the recognition of contributed services into the financial statements

Statement of Financial Accounting Standards No. 117 (SFAS 117)

SFAS 117 directs auditing CPAs in the way to prepare financial statements for not-for-profit organizations.

Highlights:

- Terminology changes
- What a complete set of financial statements includes
- Explanation of net assets in the Statement of Financial Position

Statement of Financial Accounting Standards No. 124 (SFAS 124)

SFAS 124 directs auditing CPAs on how to account for certain investments held by not-for-profit organizations.

Highlights:

- Investments include equity securities with determinable fair value.
- Investments include debt securities with determinable fair values.
- This statement does *not* apply to equity securities accounted for under the equity method or to investments in consolidated subsidiaries.

Statement of Financial Accounting Standards No. 136 (SFAS 136)

SFAS directs auditing CPAs on how to account for transfer of assets to a not-for-profit organization or charitable trust that raises or holds contributions for others.

Highlights:

- Accounting for transactions between a not-for-profit organization or charitable trust and another entity
- Contributions that are not technically contributions
- Disclosure of fund-raising expenses
- Guidance on situations where one organization has “variance power” over another

Note: For a detailed explanation of this statement, review *Preventing Fraud in Not-For-Profit Organizations*, published by John Wiley & Sons.