100 Introduction

100.1 Accounting for a nonprofit organization is unlike accounting for other entities in several ways. First, the nonprofit environment is unique and it must be understood before the accounting function can be performed properly. Secondly, certain accounting rules relating specifically to nonprofit organizations make the accounting process more complicated. Finally, many nonprofit organizations do not have the funding to hire adequate staff to handle the accounting and other administrative functions. As a result, performing the accounting function for a nonprofit organization can be very challenging.

100.2 *PPC's Nonprofit Financial and Accounting Manual* is written to assist you in meeting the challenge. The *Manual* is written specifically for you—the nonprofit accountant. It is a comprehensive, hands-on reference tool that can serve as your complete guide to the nonprofit financial and accounting function. The *Manual* provides answers to the questions most frequently asked by nonprofit accountants. It gives you step-by-step instructions for performing day-to-day nonprofit financial activities. It also provides an overview of nonprofit accounting and taxation, federal grant compliance, outside CPA assistance, budgeting, and software selection. Refer to the *Manual* any time you have an accounting question, and familiarize yourself with the contents of each chapter. The more you use the *Manual* and become comfortable with it, the more valuable it will be.

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101 The Nonprofit Environment

101.1 The “nonprofit environment” is the sum total of all the internal and external factors associated with being a nonprofit organization. To fully understand the nonprofit environment, it is helpful to know the answers to these questions:

• Exactly what *is* a nonprofit organization?

• What are the similarities between nonprofits and business enterprises?

• What are the differences between nonprofits and business enterprises?

The following paragraphs address each of these questions and provide some answers.

What Is a Nonprofit Organization?

101.2 Nonprofit organizations range in size from small local organizations to large national and international organizations. Their scope covers almost every activity imaginable—health and welfare, religion, education, research, social organizations, and professional associations. It is estimated that there are over two million nonprofit organizations in the United States.

101.3 Because there are such a variety of activities and purposes among nonprofit organizations, it is difficult to find one clear-cut definition for “nonprofit organization.” One element is common to primarily all, however: nearly all are qualified as tax-exempt under Section 501 of the Internal Revenue Code. Other distinguishing characteristics of nonprofit organizations are:

• A lack of a profit motive exists in providing services or goods.

- Activities relate to religious, charitable, scientific, literary, or educational purposes.

- Resources are contributed by parties not expecting any economic benefit in return.

- Generally there is an absence of defined ownership interests that may be sold, transferred, redeemed, or liquidated.

101.4 Several terms are used to refer to nonprofit organizations. The term *nonprofit* has been chosen for use in this *Manual*; however, the terms *nonprofit*, *not-for-profit*, and *not-for-profit entity* are interchangeable and all are appropriate.

Similarities to Business Enterprises

101.5 Although nonprofit organizations have several characteristics that distinguish them from for-profit business enterprises, they do have some similarities. For example, both nonprofit organizations and for-profit business enterprises may:

- Engage in similar activities, such as with nonprofit and for-profit schools and hospitals.

- Use resources and charge a fee or price for the goods or services provided.

- Have similar operating problems such as obtaining and managing the labor, materials, and facilities required to perform their activities.

- Have issues related to safeguarding assets.

- Incur obligations to vendors, creditors, and employees.

- Be subject to taxation, since nonprofit organizations are subject to federal and state taxes on unrelated business income.

• Be subject to state sales and excise taxes.

• Be subject to federal, state, and local regulations such as day care licensing requirements or state charities reporting requirements.

• Require sufficient financial resources to continue providing satisfactory levels of goods or services.

• Require surplus financial resources to finance growth.

Differences from Business Enterprises

101.6 It is the differences from for-profit enterprises that make nonprofit organizations unique. These differences cover a wide spectrum of areas, ranging from organizational goals, to management, to desired outcomes. Some of the distinguishing characteristics of nonprofit organizations relate to differences in:

• Organizational goals.

• Sources and uses of resources.

• Performance measurement.

• Personnel and management.

• Accounting and control matters.

• Constraints on activities.

The following paragraphs discuss these differences in more detail.

101.7 **Differences in Organizational Goals** As the name implies, nonprofit organizations do not exist to create a profit. This does not mean that they can operate in the long run with expenses in excess of revenues; they must maintain positive net assets to remain in existence over the long term. Rather than a profit motive, however, nonprofit organizations have as a primary goal the achievement of educational, charitable, scientific, or similar objectives. Nonprofit organizations exist to engage in activities or provide services, often to specific groups or in specified areas of need, that for-profit entities might shun. As a result, charitable, public interest, and social improvement considerations generally motivate the activities and operating policies of most nonprofit organizations and their staff members to a significantly greater extent than they would affect for-profit businesses and business owners or employees.

101.8 **Differences in Sources and Uses of Resources** The ways in which nonprofit organizations receive some or all of their resources represent some of the most significant differences distinguishing nonprofit organizations from for-profit business enterprises. Nonprofit organizations typically obtain resources in five ways. They may:

- *Receive Grants from Public or Private Sources.* Grants are awards of money or assets provided by government agencies, foundations, corporations, federated fundraising agencies, such as the United Way, or individuals. Grants are usually sought by nonprofit organizations on a competitive basis by submitting proposals and budgets to funding sources, which then decide which proposals to fund.

- *Receive Payment for Providing Goods or Services.* Nonprofit organizations can be paid for providing goods or services, and such payments usually take one of two forms. One form is fees from private individuals for goods or services they receive or will receive, such as program service fees billed directly to service recipients and tuition billed to school students or sales revenue from the sale of publications, reproductions, etc. Those fees may, or may not, be adequate to cover the nonprofit organization's costs for the goods or services. A second common form is reimbursement by third parties (such as insurance companies, governmental units, or others) for goods or services the organization provides to others.

- *Receive Support from Their Members.* Nonprofit organizations that define themselves in their incorporation papers or bylaws as membership organizations may receive funds from their members in the form of membership dues, or as contributions from members.

- *Receive Income from Investments.* Nonprofit organizations may receive income from investments, including rents and royalties, dividends and interest, and proceeds from disposition of investments. In some cases, this revenue may be restricted by the donors of the related investments.

• *Receive Support from the General Public.* Nonprofit organizations can also solicit contributions from the general public through direct mail, special events, delayed or planned giving, or other fundraising methods. Contributions are generally in the form of cash, securities, materials, facilities, or services.

101.9 **Different Measurement of Performance** For-profit business enterprises can usually readily evaluate overall performance by measuring profitability. Since nonprofit organizations do not have a profit motivation, there is no single performance indicator comparable to the business enterprise profit benchmark. However, there are financial performance measurements that apply to nonprofit organizations such as certain expenditure ratios. (See paragraph 107.7.) Instead of profit, nonprofit organization performance and results are usually based on the success of the organization's service efforts and other accomplishments.

101.10 Measuring a nonprofit organization's performance and results can be more complex than for a for-profit business enterprise. Depending on the nature of its goals, a nonprofit organization may have to determine what to measure, what indicators to use, and how to gather the data. In addition, different programs and activities within the same organization may require totally different measurement standards, indicators, and data. For example, a day care center's measurement standard of service efforts and accomplishments might be the number of children served, while performance of a home rehabilitation program might be measured based on the number of eligible homes renovated.

101.11 **Personnel and Management Differences** The dependence of many nonprofit organizations on voluntary contributions and on funding sources that impose restrictions on the use of their funds has implications for both management and personnel. Some of the most significant personnel and management differences affecting nonprofit organizations include:

• *Volunteer Governing Boards.* Many nonprofit organizations have volunteer governing boards whose members may serve for limited terms, possibly contributing to a lack of continuity in, or understanding of, recordkeeping requirements.

• *Restrictions on Recruitment, Hiring, and Compensation.* For-profit business enterprises can generally recruit and hire employees and set compensation within relatively broad legal limits (e.g., equal employment opportunity laws and minimum wage requirements), usually with a good deal of flexibility in filling specific positions. While nonprofit organization recruitment and hiring is also generally subject to the same broad legal limits, some organizations may also find that funding source guidelines require them to hire people from specific geographic areas or meet other hiring criteria. In addition, flexibility in filling specific positions (particularly administrative) tends to be further restricted by funding source limitations on salaries.

• *Job Security and Turnover.* Payroll is the major expense in many nonprofit organizations because they are service-oriented. Yet salary scales are often limited by budgetary requirements, and there is sometimes an uncertain future because of the year-to-year nature of outside funding. This may contribute to increased turnover of personnel, and high turnover can be disruptive to the sound operation of the organization.

• *Employee Training and Skills.* Because of the limited funding most nonprofit organizations are subject to, accounting and recordkeeping are often seen as less important than the organization's public service purposes. In some instances, this may result in too few employees to permit an adequate segregation of duties. Also, lower pay scales may result in accounting personnel whose education or experience is limited. Similarly, rapid employee turnover can mean replacements may not receive adequate training. On the other hand, some accounting personnel in nonprofit organizations are so instilled with a belief in the mission of the entity that they continue working harder for less pay than if they found a job in the for-profit arena.

• *Volunteer Personnel.* Some nonprofit organizations rely heavily on volunteers to help carry out the organization's mission, including volunteer financial management, recordkeeping, or accounting services. Volunteer staff members may be less knowledgeable or amenable to direct control than paid employees, which can affect the understanding of, and compliance with, program and accounting objectives. They may also be less reliable for performing key duties because their volunteer time may not have the same priority as regular work hours have for employees.

101.12 **Differences in Accounting and Control Matters** The previous paragraph discussed the possible negative impact of certain personnel factors on the nonprofit accounting function. A strengthening factor, however, is that nonprofit organizations often are subject to more scrutiny by outside parties than are for-profit business enterprises of similar size. Funding sources, particularly governmental funding agencies, may require periodic reporting and audits, specify monitoring and compliance practices, and reserve the right to perform audits of programs they fund. These external influences may heighten management's consciousness of the conduct of the organization's operations and may prompt management to establish specific controls not typically found in a similarly sized small business enterprise.

101.13 Because of the higher level of public scrutiny, most nonprofit organizations place great importance on the use of budgets. Most for-profit business enterprises have some form of budget and view it as a blueprint for action and a means of controlling activities and measuring results.

Budgets serve these same purposes for nonprofit organizations. However, the use of budgets is crucial to many nonprofit organizations because of the restricted nature of much of their resources. Many nonprofit organizations must prepare and closely adhere to detailed budgets for specific programs or functions. Because of funding source constraints on revenue and expenditures, budgets are often part of a contractual agreement and subject to limited flexibility. For many organizations, each budget is a plan for spending specific amounts of money in specific cost categories by line item to achieve specific goals within a set period of time. Chapter 11 discusses budgeting in detail.

101.14 **Different Constraints on Activities** For-profit business enterprises have traditionally dealt with fewer outside constraints than nonprofit organizations. Nonprofit organizations have been subject to a host of outside constraints for decades—requirements set by Congress, the IRS, funding sources, and state governments—and these outside constraints continue to increase. Although both for-profit business enterprises and nonprofit organizations face outside constraints, the nature of the constraints differs. Some of the requirements applicable to nonprofit organizations are:

- *Eligibility Requirements.* For nonprofit organizations, agreements with funding sources may specify the individuals or areas eligible to receive goods or services when the organization carries out specific programs or activities. In the case of specific eligibility requirements, such as income, age, geographic location, or others, nonprofit organizations may be required to determine eligibility before spending funds or providing goods and services.

- *IRS Requirements.* Tax exemption is a privilege granted by Congress through the IRS. In return, nonprofit organizations are subject to a range of IRS requirements different from those for for-profit business enterprises. Primary among these are requirements that a nonprofit organization's income, expenditures, and activities be substantially related to its exempt purpose; that the organization pay taxes on income from activities not substantially related to its exempt purpose; that the nonprofit organization limit lobbying activities and avoid all partisan political activities; that none of the organization's assets inure to the benefit of a private individual; that the organization be organized and operated to provide public, not private, benefit; and that specific reports be filed to demonstrate compliance in these and other areas.

- *Funding Source Requirements.* Previous paragraphs discuss the fact that funding sources often place restrictions on the use of resources provided to nonprofit organizations. Many nonprofit organizations are dependent on those funding sources; therefore, they must plan and implement programs and activities within the funding sources' prescribed parameters.

- *State Fundraising Requirements.* Fundraising is often an integral part of a nonprofit organization's existence, and a growing number of states regulate fundraising activities and require regular reports. See discussion at section 310.

Current Regulatory Developments in the Nonprofit Environment

101.15 The environment for nonprofit organizations is one of increasing regulation and an emphasis on transparency. It is important to stay current with developments at these levels:

- Federal actions

- State legislation

- Industry self-regulation

- Regulatory bodies of the accounting profession

101.16 **Federal Actions** Federal actions have been both legislative and regulatory. However, the overall developments have been steady and cumulative. They have been focused on improving nonprofit organization governance, transparency, and reporting.

- The Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act or the Act) affects nonprofit organizations even though they were not targeted by the law. Only two provisions of the Act directly apply to nonprofit organizations. However, the Act's broader impact on nonprofit organizations was felt because of the heightened awareness of governance among governing board members, auditors, and donors.

- The IRS's "Life Cycle of an Exempt Organization" (the Life Cycle), provides guidance for a nonprofit organization in all its interactions with the IRS during its existence. (The Life Cycle can be accessed at **www.irs.gov/Charities-&-Non-Profits/Life-Cycle-of-an-Exempt-Organization**.) Buried within the "Starting Out" section (one of the five major topics in the Life Cycle) is the eight-page discussion, "Governance and Related Topics," in which the IRS recommends policies and practices for consideration, organized into six topics: Mission, Organizational Documents, Governing Body, Governance and Management Policies, Financial Statements and Form 990 Reporting, and Transparency and Accountability. This discussion can be accessed at **www.irs.gov/pub/irs-tege/governance_practices.pdf**.

- In 2006, Congress passed legislation increasing the filing requirements for small nonprofit organizations. Small organizations (with annual revenues of $50,000 for tax years 2010 and later) are required to file annual informational returns with the IRS that provide a few basic pieces of information. Eligible organizations that do not meet the filing requirement for three consecutive years are subject to losing their tax-exempt status. The IRS worked with small nonprofit organizations, trying to ensure that they understood their new filing requirements and giving them extra time to file. However, in 2011, the IRS announced that 275,000 nonprofit organizations had lost their tax exemptions for failing to file their returns. Chapter 3 of this *Manual* discusses the filing requirements for nonprofit organizations of all sizes.

• The IRS instituted substantial changes to the tax return filed by many nonprofit organizations (that is, the Form 990). These changes support the IRS's position that good governance should be a top priority of nonprofit organizations. Its Tax Exempt and Government Entities Division (TE/GE) has issued several articles in recent years identifying the characteristics of an entity that has good governance. It issued a governance check sheet to be used by its agents to capture data about governance practices and the related internal controls of organizations being examined.

• In 2009, Congress passed the American Recovery and Reinvestment Act of 2009 (Recovery Act). This act details specific reporting and compliance requirements relating to grants under the Recovery Act. See Chapter 9 for additional information.

• Congress passed the Federal Funding Accountability and Transparency Act (Transparency Act). Among the Transparency Act's provisions were reporting requirements for organizations that are grant subrecipients.

• The IRS is actively looking at abuses in the areas of prohibited political activity, excessive compensation to executives of tax-exempt organizations, and abusive transactions whereby charities are the recipients of questionable donations or donations inappropriately valued. See further discussion of tax-related requirements and issues in Chapter 3.

• The Government Accountability Office is working more closely with the American Institute of Certified Public Accountants (AICPA) to ensure that auditors understand their unique responsibilities when auditing grant recipients. The impact of these provisions on nonprofit organizations is discussed in Chapter 9.

101.17 **State Legislation** Each state regulates nonprofit organizations. Many states are considering or passing legislation regulating nonprofit accountability, governance, and charitable solicitation. Accountability legislation typically addresses which nonprofit organizations must report data, what data must be reported, and how the data will be used. Some states have passed legislation requiring, among other things, that nonprofit organizations with a certain level of gross revenue have an independent financial statement audit. The National Council of Nonprofits (NCN) monitors state legislature activity. The NCN website is **www.councilofnonprofits.org**. Their website provides links to the websites of state associations of nonprofits.

101.18 In most states the office of attorney general or the secretary of state regulates charitable organizations and solicitations. The National Association of State Charity Officials (NASCO) provides contact information for the appropriate state office regulating nonprofits in each state at **www.nasconet.org/category/info-charities**.

101.19 **Industry Self-regulation** The Panel on the Nonprofit Sector (the Panel), which is a panel convened by the Independent Sector in response to the Senate Finance Committee's push to reform tax-exempt organizations, released four reports providing recommendations about good governance. (Independent Sector is a coalition representing about 600 nonprofit organizations.) The first report, “Strengthening Transparency, Governance, and Accountability of Charitable Organizations,” was issued in June 2005. It was followed by a 44-page supplement in April 2006. These two reports were followed in October 2007 by a third, “Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations.” Finally, in 2009, the Panel released its “Principles Workbook: Steering Your Board Toward Good Governance and Ethical Practice,” a tool designed to help the board and staff of a nonprofit organization examine and improve their governance practices. The four reports are available at **www.nonprofitpanel.org/Report/index.html**.

101.20 **Regulatory Bodies of the Accounting Profession** The AICPA, through its Auditing Standards Board, issues auditing and professional ethics standards that affect the outside auditor of nonprofit organizations, as well as all entities. These standards are discussed in Chapter 10.

101.21 With so many organizations focusing on improving governance, transparency, and reporting and offering different suggestions, it can be difficult for a nonprofit to identify and implement appropriate procedures. *PPC's Guide to Nonprofit GAAP*, *PPC's Guide to Nonprofit Contributions*, *PPC's Guide to Nonprofit Expenses*, and *PPC's Nonprofit Tax and Governance Guide*, along with other PPC nonprofit titles are available online at **tax.thomsonreuters.com** or at (800) 431-9025.

Accounting Standards Setters

101.22 The Financial Accounting Standards Board (FASB) created the Not-for-Profit Advisory Committee (also known as the NAC) in 2009 to advise the FASB on issues unique to nonprofit entities. The NAC's input covers both proposed and existing standards and other issues important to the nonprofit industry. NAC meetings provide an important discussion forum on critical issues and a means of receiving input from the nonprofit sector. In addition to providing focused input from the sector, the NAC helps the FASB Board and staff in communicating to the sector about recent and other existing guidance, current and proposed projects, and important issues. NAC members include auditors, preparers, and users of nonprofit financial statements.

101.23 In response to NAC's recommendations, FASB added two projects to its agenda; one of which the Board voted to remove. The other, a standard-setting project, is still in process and focuses on the financial statements and related notes that are unique to nonprofit organizations. It is reexamining existing standards for financial statement presentation with a focus on improving the current net asset classification scheme and information provided about an organization's liquidity, financial performance, and cash flows. The FASB issued an exposure draft for public comment in April 2015. The public comment period ended August 20, 2015. The FASB is now redeliberating the proposed changes and plans to issue a final accounting standard addressing some of the items in the exposure draft during 2016. The remaining issues from the exposure draft will be addressed separately after the completion of the first phase of the project as those issues were more contentious and will require more time. The FASB has not indicated what the effective date would be for any resulting new accounting standard. Future editions of this *Manual* will update the status of this project. The NAC's meetings and other FASB activities such as the Exposure Draft can be followed at **www.fasb.org**.

Effects of the Economy

101.24 Although the U.S. economy has been improving over the past few years, contributions to nonprofit organizations have not returned to the levels seen before the most recent economic crisis. Demand for the services of nonprofits is increasing, however, and government funding is decreasing in some service areas. This challenges nonprofit organizations to become more efficient and consider making capital investments that will lower costs in the future. Another challenge is finding and hiring skilled workers to meet the increased demand for services. Contributing to the difficulty of finding workers are several factors such as the decrease in the unemployment rate in recent years from 9.3% in 2009 to 6.2% in 2014. Other factors are the aging of the workforce and retirement of many key employees. Nonprofit organizations are reacting to these challenges by forming alliances with for-profit businesses and outsourcing services. This adds new complexities to operating activities.

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102 Designing the Accounting System

102.1 The organization's accounting system is responsible for tracking and summarizing the hundreds or even thousands of monthly transactions into a manageable, understandable format. The monthly financial transactions typically start with one or more source documents (such as invoices, cash receipts, and time sheets), that are posted to specific general ledger accounts. The ending monthly general ledger balances are then used to generate the organization's financial statements.

102.2 Because no two organizations are exactly alike, it is difficult to design a single accounting system that will work for all entities. For example, an accounting system designed to meet the needs of a social service organization may not accumulate all of the transactions or provide the financial information necessary for a museum or private school. Even if the types of activities are similar, every organization's accounting system should be modified to meet the individual needs of the organization. Accordingly, an accounting system should be designed specifically for the organization.

102.3 Designing the accounting system is perhaps the organization's single *most* important accounting project. Do not hesitate to consult with the organization's outside CPA for advice in this area. It is much easier to take additional time and effort to set up the accounting system properly from the beginning than to try to modify or fix the system design later.

102.4 When designing the organization's accounting system, consider the following:

- Keep the system simple.

- Determine what information the system should provide.

- Identify chart of account segments, such as functions, revenue sources, and self-balancing funds.

- Develop general ledger accounts and the lists for the other segments.

- Automate the system.

The following paragraphs discuss these factors for consideration when designing an accounting system.

Keep the System Simple

102.5 Keep the accounting system as simple as possible. Unnecessarily complex systems are inefficient, hard to use, and often difficult to understand. For most organizations, an elaborate recordkeeping system is not needed. The system should be only as complex as necessary to adequately process transactions and provide meaningful financial information. More complexity than necessary can cause problems in the long run.

Determine What Information the System Should Provide

102.6 The system should be designed to produce useful financial information. In order to decide what information the system should be designed to provide, three important questions must first be answered:

- Who will be the users of the financial information?

- How will they use the information?

- What type of financial information will the users need?

Only after addressing these questions can the system be properly set up. The following paragraphs briefly discuss each of the three questions.

102.7 **Who Will Be the Users of the Financial Information?** First and foremost, the organization's accounting system should be set up to provide meaningful financial information for the organization's management and governing board members. This financial information should provide sufficient data for management and the board to make knowledgeable decisions about the organization's activities and programs. Most organizations also have users of financial information that are outside the organization, such as funders, contributors, and government agencies. The accounting system should be set up to generate financial information to meet the needs of outside financial statement users, as well as organization management.

102.8 **How Will They Use the Information?** Different users of financial information typically have different needs for the information. For example, an organization may include financial information in a grant proposal to a potential funding source. The grantor will then use the financial information to evaluate the organization's grant request. If possible, the accounting system should be set up to accommodate the various users of the financial information.

102.9 **What Type of Financial Information Will the Users Need?** The accounting system should be set up to generate different types of financial information for the primary users. The organization's board and management will likely need financial information comparing budgets to actual results so they can effectively manage the programs and activities. Most external users, however, will desire to see financial statements prepared in accordance with generally accepted accounting principles. In addition, many funders may also desire to see detailed information about the programs they fund. Therefore, the accounting system should be detailed enough to accommodate all three types of reporting. To illustrate, assume an organization receives grant funding for a certain program. In addition to financial statements prepared in accordance with generally accepted accounting principles, the grantor may request separate financial information relating only to that specific program. The organization must then track and report the expenses incurred in that program, so the accounting system would need to be set up to accommodate recording of costs by program (function). Chapter 8 discusses external and internal financial statements.

Identify Chart of Account Segments

102.10 Once the various types of financial information to be provided by the system are determined, the segments that make up the chart of accounts can be determined. These typically include a segment that is a self-balancing fund for tracking restricted and unrestricted net assets and segments for tracking income and expenses by function and by revenue source. Other segments can include specific locations or projects.

Develop General Ledger Accounts and Lists for the Other Segments

102.11 The next step is to develop the organization's general ledger accounts, known as the chart of accounts. The chart of accounts is a comprehensive listing of all the accounts used by the organization. All of the organization's transactions are coded to specific general ledger accounts; the transactions are then recorded, grouped and summarized by account type. In addition, the lists of items included in the other chart of account segments must be identified. Think of the chart of accounts, including general ledger accounts and the other segments, as the foundation upon which the general ledger is built. Without a well conceived, carefully developed chart of accounts, it is difficult to prepare meaningful financial statements. Therefore, the importance of a good chart of accounts cannot be overemphasized. Section 713 discusses the chart of accounts in more detail.

Automate the System

102.12 Computers and related software are more efficient than the best manual systems. As a result, manual accounting systems are seldom used. Using accounting software, the appropriate special journals and general ledger can be produced by merely entering the transactions and adjustments and instructing the software to post the entries. Once the general ledger is produced, the software can also be used to generate financial statements. In addition, general ledger software packages usually are integrated with modules for accounts receivable, accounts payable, inventory, and payroll. When those modules are used, transactions entered are posted to both the general ledger and subsidiary ledgers for those accounts. Chapter 12 discusses selecting computer software in detail.

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103 Internal Control

103.1 Internal control must be integrated into the overall design of the organization's accounting system. But what does it all mean? The following paragraphs explain the basics of internal control.

What Is Internal Control?

103.2 Internal control is a process used to obtain reliable financial reporting, effective and efficient operations, and compliance with laws and regulations. This definition is very broad and encompasses many policies and procedures unrelated to the accounting function. Narrowing the definition to areas that relate to accounting and reporting, internal control consists of the methods and records used to (a) identify, assemble, analyze, classify, record, and report the organization's transactions, events, and conditions and (b) maintain accountability for the related assets and liabilities.

103.3 In other words, internal control is the organization's system of internal checks and balances. Controls are established to reduce the potential for misuse of the organization's assets or misstatement of account balances. Most people are aware that internal control helps deter fraud within the organization. Control activities benefit employees as well as the organization because such activities protect honest employees from being falsely accused of fraud or misuse of assets.

103.4 In addition to preventing, detecting, and deterring fraud within the organization, good internal control can positively impact nonprofit organizations in many ways, including the following:

- Conserve the organization's resources for use in accomplishing the organization's mission.

- Ensure compliance with regulations and donor requirements, thus fulfilling the organization's stewardship responsibility to donors and regulatory agencies and building the confidence of the organization's donors and the general public that the funds are being used appropriately.

- Ensure accurate financial reporting.

- Assist the organization in maintaining a good reputation.

103.5 Some accountants may not be involved in establishing internal control, while others may be responsible for their organization's internal control. Even if you are not responsible for setting up controls for your organization, it is helpful to have a basic understanding of internal control to carry out your daily duties.

103.6 Internal control consists of five components:

- Control environment.

- Risk assessment.

- Control activities.

- Information and communication.

- Monitoring activities.

The following paragraphs discuss each of these components.

Control Environment

103.7 The control environment is the set of standards, processes, and structures that provide the basis for carrying out internal control across the organization. The tone at the top, set by the board of directors and senior management, establishes the importance of internal controls, including expected standards of conduct. Management reinforces those expectations across the organization. The control environment comprises the integrity and ethical values of the organization, the oversight by the board of directors, the assignment of authority via the organizational structure, the process for hiring and retaining competent people, and the attention directed at accountability for performance. The control environment has a pervasive impact on the system of internal control. The control environment reflects how much importance the organization places on controls as a part of its daily activities. The organization should include a positive attitude about controls in all facets of its activities.

Risk Assessment

103.8 Risk assessment is a dynamic and iterative process for identifying, assessing, and managing risks. A precondition to risk assessment is the establishment of objectives. Management specifies objectives for operations, reporting, and compliance that are clear enough to allow the organization to identify and analyze risks to the achievement of those objectives. Risk assessment also requires management to consider whether changes in the external environment and the organization's business model may render internal control ineffective. For example, the organization's assessment of the risk that not all contributions are being recorded in the accounting system will affect the controls that the organization puts in place to ensure that all contributions are properly captured and recorded.

Control Activities

103.9 Control activities are the policies and procedures set up to help ensure that management directives are carried out. Control activities are performed at all levels, at various stages within the operations, and over the technology environment. Control activities may be preventive or detective in nature. Some may be manual; others automated. Segregation of duties is generally built into the selection and development of control activities, but if segregation is not practical, management selects and develops other control activities. An example of a control activity in the cash receipts area is the organization requiring all mail to be opened in the presence of two people. Control activities, whether automated or manual, cover a range of activities and may include the following.

Information and Communication

103.10 Information is necessary for the organization to perform its control responsibilities so that objectives are achieved. Management gathers or creates information about the functioning of internal control from both internal and external sources. Communication is the continual, iterative process of providing, sharing, and obtaining information. Internal communication informs personnel that control responsibilities are important. External communication is twofold: it brings into the organization relevant external information, and it provides information to external parties in response to their requirements and expectations. An example of information and communication is the organization's policies and procedures manual, which should include instructions on how to document and record contributions, including promises to give.

Monitoring Activities

103.11 Monitoring activities are activities that assist the organization in determining whether each of the five components of internal control is present and functioning. Monitoring includes both ongoing evaluations and separate evaluations. Ongoing evaluations are those built into the organization's processes at different levels; they provide information on an ongoing and timely basis. Separate evaluations are those that are performed periodically; they vary in scope and frequency depending upon the assessment of risks. Findings of monitoring activities are evaluated against criteria established by regulators, standard-setting bodies, or management and the board of directors; deficiencies are communicated to management and the board of directors as appropriate. The board of directors' review of complaints from donors relating to discrepancies noted in thank-you letters is an example of monitoring.

Which Controls Are Necessary?

103.12 It is essential to establish, implement, and maintain the five components of internal controls identified in paragraph 103.6. The design of the internal controls will depend on the size of the organization and on the individual facts and circumstances that are unique to your organization. Remember, the goal of internal controls is to provide effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. Selecting the appropriate mix of controls often depends on factors such as the type of accounting system, the nature and volume of accounting transactions, and staffing levels.

Additional Information on Internal Control Components

103.13 **COSO Report** The Committee of Sponsoring Organizations (COSO) of the Treadway Commission is a group of private organizations that work together to improve financial reporting. COSO looks at business ethics, internal controls, and corporate governance. COSO is best known as the issuer of the widely-accepted *Internal Control—Integrated Framework* (COSO Framework), issued in May 2013. COSO documents are available through the AICPA at **www.cpa2biz.com**.

103.14 In January 2009, COSO issued the first portion of a document that focuses specifically on monitoring an internal control system. *Guidance on Monitoring Internal Control Systems* was developed to clarify the monitoring component of the internal control framework. In this document, COSO explains how organizations can use the guidance in the COSO Framework to implement effective and efficient monitoring. The document can be purchased from the AICPA at **www.cpa2biz.com**. From 1999 through 2013, COSO also issued many documents on enterprise risk management and fraud deterrence that are available for download at no charge on its website at **www.coso.org**.

103.15 **AICPA Audit Committee Toolkit** The AICPA has published a toolkit that includes expanded information on internal control and the audit committee's responsibilities. See the discussion at section 1002.

Auditor Communications about Internal Control Related Matters

103.16 Auditors are required to communicate in writing to the organization's management and governing body any significant deficiencies and material weaknesses in internal control that come to the auditors' attention during the course of the audit that related to the organization's internal controls. Auditors may communicate other less significant control deficiencies either orally or in writing.

103.17 See the discussion of the auditor's communication responsibilities at section 1002.

103.18 Some nonprofit organizations receive grants from the federal government. In those cases, there may be additional reporting requirements relating to internal control deficiencies.

103.19 **The Organization's Responsibility** To avoid such auditor communications concerning internal control, at a minimum, the organization should have on staff or have an advisory relationship with accounting personnel who have the skills to (a) understand generally accepted accounting principles (GAAP); (b) obtain and process financial information so that the financial statements are in accordance with GAAP, including disclosures that are required to accompany financial statements; and (c) develop and document internal control policies and procedures the organization uses to ensure financial statements are accurate and complete. If an organization does not have adequate internal control over financial reporting and instead relies on its auditors to identify adjustments to the financial statements (such as depreciation expense and contributions) the organization faces receiving a written communication from the auditor stating the organization's internal control over financial reporting has significant deficiencies or even material weaknesses. Organizations should consider the impact such written communications could have on donors' or grantors' perception of the organization.

103.20 The organization should have internal control over financial reporting so that even transactions that are not part of the organization's routine are properly recorded and reported. Chapters 4 through 6 of this *Manual* discuss how to handle the routine cash receipts and disbursements and payroll transactions encountered by most nonprofit organizations. Chapters 2 and 7 of this *Manual* discuss the nonroutine transactions—recording investments, promises to give, or leases; adjusting year-end accruals; and allocating expenses. Nonprofit organizations that are unable to record all material adjustments prior to submitting the trial balance for audit, identify all required note disclosures, and at least provide the information required in the note disclosures face receiving unfavorable required written communications from their auditors concerning the organization's internal control over financial reporting. Section 1002 discusses ramifications of such communications, and paragraph 1004.2 discusses the organization's responsibilities for preparing the financial statements.

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104 Documenting Internal Control

104.1 The emphasis on internal control is growing stronger. Passage of the Sarbanes-Oxley Act started the process, congressional activity and the response from the Panel on the Nonprofit Sector brought the issue firmly into the nonprofit arena, and more recently changes in auditing standards are giving the issue a still higher level of importance and an urgency to implement internal control.

Policies and Procedures Manual

104.2 It is difficult to assess the adequacy of internal control if the organization does not document policies and procedures. Many organizations choose to formally document their policies and procedures using a manual that is adopted by the governing board. A policies and procedures manual should address:

- Basic procedural controls over receipts, expenditures, assets, and liabilities.
- Monitoring activities.
- Governance policies.
- Other policies that enhance transparency and oversight pursuant to recommendations from the Panel on the Nonprofit Sector designed to encourage nonprofit organizations to self regulate.

104.3 **Basic Procedural Controls** This section of the policies and procedures manual includes control activities outlined in paragraph 103.9 that are designed to prevent or detect errors and fraud and ensure accurate and timely financial reporting. It should detail specifically which staff, board members, or other volunteers perform the various tasks associated with the entire accounting and finance function, especially clarifying who has access to the accounting system and who has access to assets of the organization.

104.4 This section of the manual can include or reference job descriptions (including board member responsibilities, if relevant), chart of accounts, a list of brokerage accounts, bank accounts, and authorized signers, and any forms and processing checklists used to implement the procedures. It should state the basis for accounting (cash, accrual, or a hybrid) and the fiscal year-end date. It should include the threshold for capitalizing purchases. The organization can also include policies about investments, appropriate travel expenses, expense reimbursements, and the use of corporate credit or debit cards.

104.5 Many of the chapters of this *Manual* include example policies and procedures with the relevant topics. For example, Appendix 2B lists example capitalization policies, Appendix 2C lists example collections policies, and Chapter 4 includes procedures an organization can use to process cash receipts and revenue.

104.6 **Monitoring Activities** Monitoring activities include internal monitoring by management and the governing board and external monitoring by third parties. As with the basic procedural controls section, this section should detail processes management employs for monitoring financial activity through reporting and analysis. It would include a list and description of the financial reports used, who is responsible for issuing each report, the frequency of issuing each, to whom each is issued (specific staff positions, committees, or the board), who is responsible for addressing and investigating questions and concerns, and who is responsible for reviewing and approving the reports. The list of reports should include departmental-level reports as well as interim and year-end financial statements.

104.7 Internal monitoring would also include documenting any internal audit procedures for monitoring the ongoing effectiveness of internal controls, both at the design and the operation levels, and for testing transactions or balances resulting from the organization's activities.

104.8 Policies and procedures related to external monitoring address reporting to governmental entities such as the IRS or state attorney general, grantors, and independent auditors.

104.9 **Governance Policies, Transparency, and Oversight** This section of the policies and procedures manual should include:

- Conflict of interest policy and disclosure procedures (see discussion at paragraph 106.12).

- Whistle-blower protection policy including processes for dealing with complaints.

- Code of conduct including guidelines for self-evaluating conduct (see section 106).

• Excess benefits policy defining procedures for determining compensation levels for highly-paid employees and documenting the determination process (see section 303).

• Record retention and destruction policy (see section 714).

• Audit committee responsibilities and qualifications of committee members (see section 1002).

104.10 **How to Create a Policies and Procedures Manual** Creating a policies and procedures manual takes some time. Samples of many of the policies, procedures, and templates that should be included can be found on the web. Procedures can be documented by interviewing the personnel who perform the procedures or those who supervise. However, it is important to analyze existing procedures to determine that the procedures result in controls that work, i.e., the controls prevent and detect errors and fraud. The Nonprofit Resource Center sells a template for model policies and procedures for nonprofit organizations that is very comprehensive and fully and easily customizable. It can be found at **www.NonprofitResource.com**. After the policies and procedures manual is completed, the governing body should formally adopt it.

104.11 Additional guidance on compliance is available in *PPC's Nonprofit Tax and Governance Guide: Helping Organizations Comply*, which can be ordered by calling (800) 431-9025 or online at **tax.thomsonreuters.com**.

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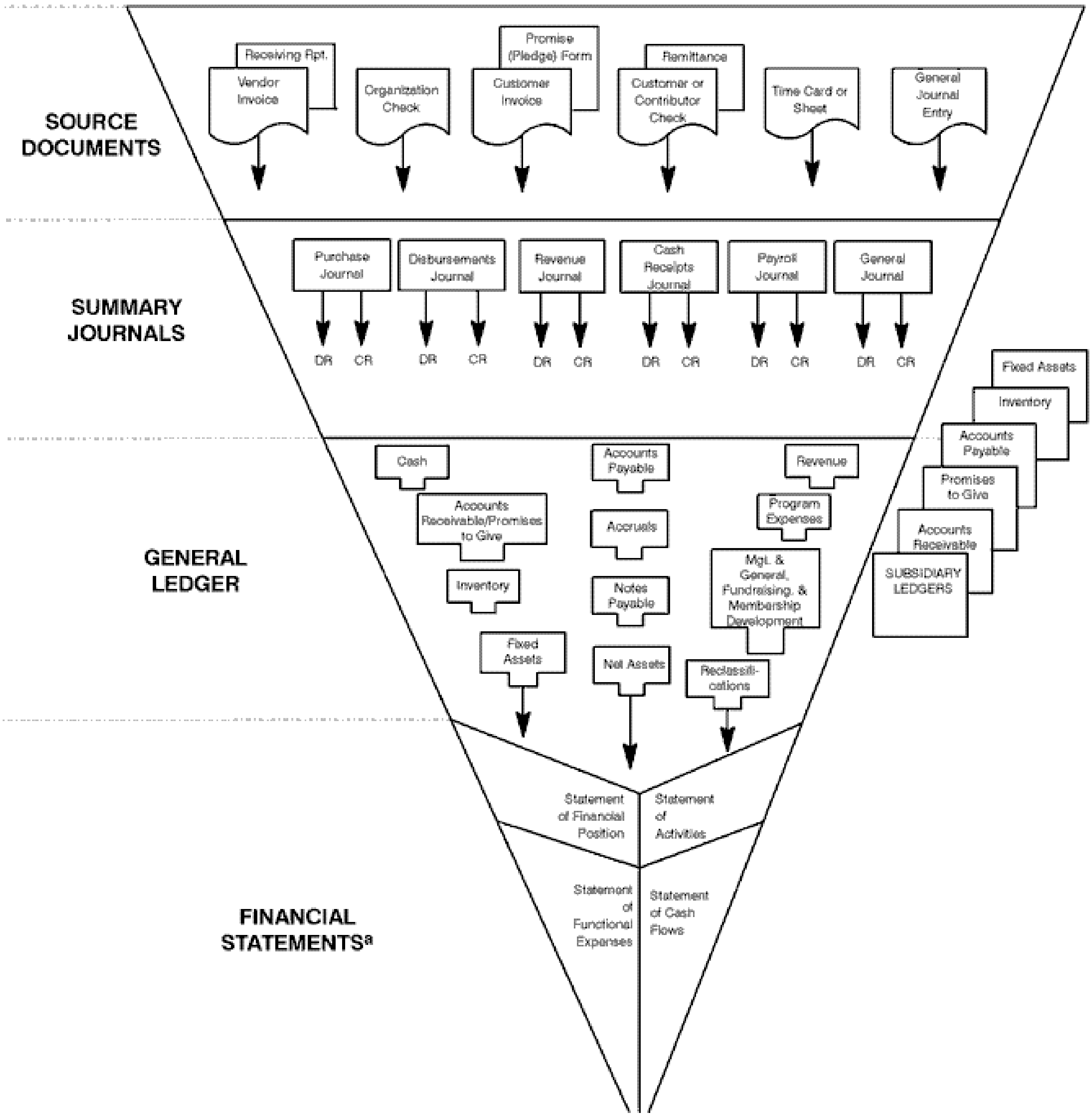
105 The Primary Accounting Processes

105.1 The overall purpose of the accounting function is to accurately process, record, summarize, and report transactions of the organization. Exhibit 1-1 presents inverted pyramids illustrating how source documents and other financial records are processed through the accounting system each month to produce the organization's financial statements.

Exhibit 1-1

Flow of Accounting Records



Notes:

[a] These financial statement titles are examples only. Chapter 8 explains which financial statements are needed and how to prepare them.

105.2 Nonprofit accounting processes generally fall into one of four primary accounting processes, or cycles. As the organization accountant, you may be responsible for all of a cycle or only a part of a cycle. Either way, it is important to have at least a basic understanding of each of the cycles. A nonprofit organization's primary cycles include:

- Revenue, accounts receivable, and cash receipts.

- Purchases, accounts payable, and cash disbursements.

- Payroll.

- General ledger and financial statements.

Each cycle is briefly discussed in the following paragraphs.

Revenue, Accounts Receivable, and Cash Receipts

105.3 This process or cycle varies depending on the nonprofit organization's activities. The cycle typically consists of generating revenue from contributions and from services provided or goods sold, and receiving payment from customers.

105.4 The principal accounting steps in the cash receipts cycle are:

- Making deposits.

- Processing cash receipts.

- Posting cash receipts in the general ledger and subsidiary records.

- Processing revenue transactions.

- Recording revenue transactions in the general ledger and subsidiary records.

- Performing month-end reconciliation procedures.

Chapter 4, Processing Revenue and Cash Receipts, discusses these steps in more detail.

Purchases, Accounts Payable, and Cash Disbursements

105.5 This cycle represents the purchase of goods and services by the organization and the subsequent payment for those goods and services. The purchase and payment cycle processes vary depending on whether the organization is large or small (see discussion beginning at paragraph 108.3).

105.6 **Small Organizations** In small organizations, the basic accounting steps in the purchase and payment cycle are:

- Processing invoices.
- Issuing checks.
- Recording checks in the general ledger and subsidiary ledgers.
- Performing month-end reconciliation procedures.

105.7 **Large Organizations** In large organizations, the primary accounting steps in the purchase and payment cycle are:

- Processing purchase transactions.
- Recording purchase transactions in the general ledger and subsidiary records.
- Disbursing cash.
- Performing month-end reconciliation procedures.

Chapter 5, Processing Purchases and Payments, provides an in-depth discussion of the purchase and payment cycles.

Payroll

105.8 The payroll process consists of processing payroll and remitting amounts due to employees, the government, and others (health insurers, retirement plan trustees, etc.). The typical accounting processes relating to payroll consist of the following:

- Obtaining and gathering payroll information for processing.
- Computing wages and withholdings.
- Preparing payroll checks or direct deposits and remitting payroll taxes.
- Performing month-end reconciliation procedures.
- Preparing quarterly payroll tax returns.
- Preparing W-2s, the W-3, and other annual payroll tax returns.

Chapter 6, Processing Payrolls, covers all aspects of the payroll process in detail.

General Ledger and Financial Statements

105.9 The general ledger process consists of posting the period's transactions to the general ledger and preparing financial statements. The accounting processes relating to the general ledger closing cycle include the following:

- Preparing monthly journal entries.
- Reconciling bank accounts and other general ledger accounts.

• Reviewing general ledger activity and posting adjusting journal entries.

• Producing the general ledger and financial statements.

Chapter 7, Maintaining the General Ledger and Recording Adjustments, provides a detailed discussion of the general ledger closing process.

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