Beyond the Checkbook:

A Financial Management Guide for Leaders of Small Youth-Serving Organizations

January 2009

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Foreword

If you are reading this foreword, you may be one of the dedicated and entrepreneurial individuals who, during the past several decades and with the support of public funding and private investments, have helped create many new programs aimed at improving outcomes for youth. If you are a part of one of these newly formed organizations—or organizations that have expanded their missions and services—then you know the serious challenges to your organization's survival.

- Your organization must find effective and efficient ways to operate.
- Your organization faces intense competition from the scores of existing youth development programs nationwide in the struggle to secure funding.
- Funding for youth programs tends to be fragmented and often short term, as does funding for most human services programs.

Solid financial systems are needed to meet these challenges. While starting or expanding a youth-serving program, it's common to focus exclusively on defining the mission and building the program. Yet this focus can come at the expense of creating the internal systems that keep your initiatives running. Enthusiasm and commitment are essential elements, but you can work more effectively if you take the time to establish policies and processes that will keep your organization's financial house in order.

Solid financial systems are needed to meet these challenges.

Youth Programs Defined

Throughout this guide, the term "youth programs" is used to describe a wide range of services and activities for youth. Youth programs include prevention, intervention, and developmental programs across multiple disciplines, including academics, workforce preparation, health and well-being, leadership and civic engagement. These programs are provided by large and small and public and private organizations in diverse settings such as schools, workplaces, and community centers. Youth program activities include counseling, mentoring, career exploration, summer employment, dropout prevention, financial literacy, academic assistance, and sports and recreation.

About This Guide

This financial management guide is for leaders of small youth-serving organizations. (By small, we mean organizations or programs with budgets of less than $2 million.) We understand that managers of youth-serving organizations often come to their positions with keen insights into providing effective programs for youth but less experience in handling the finances of an organization. Our hope is that this guide will help executive directors, directors of finance and administration, and program managers bridge that gap and understand the dynamic between the operations and the finances of their organization.

The guide aims to help leaders of small youth-serving organizations develop the tools and knowledge they need to create and use sound financial management practices. It identifies key components of financial management systems, discusses important considerations and trade-offs that organizations make in designing systems, and provides additional resources for those seeking to pursue specific strategies. The guide also contains checklists, examples, and templates to help clarify key ideas.

Financial management systems can be complicated and every organization is unique. Not every situation that a small youth-serving organization might face will be addressed in this guide. For more information, use the resources listed at the end of each chapter or contact a finance professional.

Cheryl D. Hayes

President and Chief Executive Officer

Chapter 1

Thinking About Nonprofits

Many programs that serve youth begin as special projects or initiatives housed in existing organizations. Successful projects or initiatives sometimes become their own independent organizations, usually nonprofit corporations. This chapter explains the advantages and disadvantages of forming an independent nonprofit and introduces the basic legal requirements to maintain nonprofit status. (Most of the organizations serving youth that decide to incorporate also decide to act as nonprofit entities, so this guide focuses on nonprofit financial management. However, many of the chapters are relevant regardless of tax status.)

1.1 How Nonprofits Differ from For-Profits

For-profit and nonprofit organizations vary in several ways. Most importantly, their main objectives are different: for-profits are in business to make money, while nonprofits are in business to advance a specific mission. Following is a summary of the most significant differences between the two types of entities.

For-Profits	Nonprofits
• Are owned by individuals or stockholders and are accountable to them. • Are typically driven by profit and return on investment. • Are subject to income, property, sales, and use taxes. • Have customers.	• Have no owner and are accountable to the board of directors and funders. • Are driven by mission. • Are tax-exempt, except for income from business unrelated to their mission. • Have clients and other stakeholders.

1.2 Advantages of a Nonprofit Corporation

Nonprofit status offers certain advantages over for-profit status. These include exemptions from many federal and state taxes, eligibility for additional funding, a separate legal life, flexibility in organizational structure, and lower postage rates.

Tax-exempt status. Most nonprofits qualify for federal tax exemption; few, if any, assets and income sources will be taxed. Federal tax exemption requires an application to the Internal Revenue Service (IRS). Moreover, the federal tax exemption usually qualifies the organization for exemption from state and local taxation; the organization will likely need to complete a separate application process through the state. Tax-exempt status does not necessarily mean the organization will not owe any taxes. Some sources of income unrelated to the mission of the organization, known as unrelated business income (e.g., rental property and advertising income), are subject to taxation.

Eligibility for public and private funding. Nonprofits are eligible to apply for and accept various public and private funding, some of which may not be available to for-profit organizations. Nonprofits can also solicit gifts, bequests, and donations from the public that are tax deductible for the donors (i.e., contributors may deduct these gifts from their income taxes). The tax impacts vary; restrictions exist on the deductibility of some donations and every individual has different tax circumstances.

Separate legal life. A nonprofit is its own legal entity. Although an individual or a group must create a nonprofit organization, the organization exists separately from the people who form it. Nonprofits can conduct business, borrow money, enter into contracts, own property, and sue and be sued. Nonprofit organizations exist until they are dissolved, despite employees coming and going. They also have limited liability. This means the organization is liable for its debts and for court judgments against it, but the founders and directors are rarely personally responsible for the debts.

TIPS

Insurance for the Director, Officers, and Other Board Members Is a Good Idea

Secure director's and officer's (D & O) liability insurance, even though nonprofit founders and directors have limited liability from debts and lawsuits. If you are a director and an officer who stays informed and takes an active role in understanding your organization and its financial position, you fulfill your fiduciary duty. By doing this, you reduce your liability. Regardless, in the event of extraordinary circumstances D & O liability insurance protects the director, officers, and other board members from most exposure to civil actions against them. Be sure to shop around for the best policy.

DEFINITIONS

Not all non-profits are alike

The Internal Revenue Service has different rules for different kinds of nonprofits. Most youth-serving organizations are considered charitable organizations and have 501(c)3 status, but there are other categories of nonprofits:

- churches and religious organizations;
- political organizations;
- private foundations; and
- other nonprofits (for example, certain pension and life insurance companies).

Flexible organizational structure. Nonprofit organizations have a defined operating structure and procedures, including bylaws and a board of directors. Incorporation places the purpose and structure of an organization above personal interests and differences of opinions among and between directors and founders. Operating as a nonprofit also affords discretion in defining the fiscal year and exemption from certain federal labor rules.

- Customization in defining the fiscal year. Nonprofits are not required to match their financial recordkeeping with the calendar year. They can elect any 12-month period as a fiscal year. This enables you to set the fiscal year in terms of funding or program cycles in a way that makes the most sense for your organization and its programs. For example, if your programs operate on an academic schedule, you may want to set or change the beginning of your fiscal year to September 1.
- Exemption from federal labor rules. In some states, nonprofits are exempt from federal labor rules tied to the National Labor Relations Act. In these cases, your organization is not subject to requirements for collective bargaining on wages and benefits, nor is it obligated to allow unionization in the workplace.

Lower postage rates. Most nonprofits can use the U.S. Postal Service at substantially reduced rates after receiving a special permit.

1.3 Disadvantages of a Nonprofit Corporation

Creating a nonprofit corporation also has its disadvantages, including the costs of incorporating, legally required paperwork, various restrictions, and scrutiny by outsiders.

Costs of incorporating. In addition to the time and effort involved in incorporating, there are legal costs and filing fees. Many organizations choose to consult with lawyers and/or accountants during the incorporation process. The services of these individuals may or may not be donated and can be expensive. In addition to the fee to file for a tax exemption at the federal level, nonprofits face a fee at the state level, which can range from $10 to $165.

Legally required paperwork. Incorporation requires considerable paperwork and can be a time-consuming process. Some documents (e.g., bylaws and articles of incorporation) must be prepared in a specific way and filed with the appropriate state agency. There are many reports to file (e.g., tax forms), and some of the forms are long and complex. IRS approval can take six to nine months, while approval of state sales tax exemption typically takes one month.

Restrictions on governance and finance. Incorporation creates a formal structure for governing an organization. The bylaws and articles of incorporation govern nonprofits, and a majority vote by a quorum of board members is often the only means to change policies. Nonprofit status also requires limitations on advocacy activity and on the use of unrelated business income. Moreover, if board members allow the organization to drift from its original charitable mission, they may lose their corporate liability protection as well as the organization's tax-exempt status.

Outside scrutiny. Nonprofit status comes with public scrutiny. Any forms filed with public agencies are available for public review. This includes information on salaries, expenditures, and activities.

TIPS

Nonprofits and Advocacy Are a Delicate Mix

Follow the IRS regulations that affect a 501(c)3 organization's ability to conduct public policy advocacy. The IRS divides advocacy into two categories: political campaign activity and lobbying activity.

- Political campaign activity on behalf of a candidate is absolutely forbidden, including making contributions and issuing public statements for or against a candidate. However, activities that encourage people to participate in the political process, such as voter registration drives, or that educate voters about certain issues, such as constituent forums, are acceptable.
- Lobbying to impact legislation is acceptable, so long as that effort is not a substantial part of an organization's activities.

Very specific guidelines are provided for these actions. If an organization plans to conduct advocacy activities, it is a good idea to check the IRS regulations beforehand.

1.4 Pros and Cons of Forming an Independent Nonprofit

Your youth-serving program may start out as part of a larger nonprofit organization. As it grows and matures, you may consider forming an independent entity. Following is a list of pros and cons that can help you decide whether it is better to operate under the umbrella of a larger organization or to be independent.

Operate Through an Existing Organization	Form a New Organization
Pros	**Pros**
• **Simplicity.** You can avoid costly and time-consuming startup costs. • **Resource sharing.** You can use the resources (e.g., office space, administrative and staff support, institutional knowledge, and access to partnerships) of the existing organization. • **Less risk.** You can rely on support from the umbrella organization while developing stable funding.	• **Own identity.** You can create your own distinct brand and identity. • **Independence.** You can set your own operating procedures. • **Little baggage.** You do not have to deal with any negative associations with, or turf issues within, an umbrella organization.
Cons	**Cons**
• **Less independence.** You may have to follow certain operating procedures set by the existing organization. • **Potential turf issues.** You may have to navigate turf issues or office politics in the larger organization. • **Limited funding opportunities.** Your sponsor may designate certain funders as off limits if the sponsor already receives grants from that funder. Some funders may not like giving to programs through a fiscal sponsor.	• **Startup costs.** You may need more time and money for planning. • **Risk.** It may be harder to build diverse sources of funding to support long-term programming. • **Lack of reputation.** You must build organizational awareness and credibility before receiving support from funders.

Consider these issues to help determine whether an existing organization is the right place to house your youth program.

- **Compatible mission.** Does the organization's mission fit well with your program's mission?
- **Supportive structure and policies.** Does the organization have an administrative structure and employment policies that will support your program?
- **Strong reputation.** Does the organization have a strong reputation for fiscal integrity within the community?
- **Reasonable fee.** Does the organization charge a reasonable fee for serving as the fiscal agent, usually 5 percent to 10 percent of your program's annual budget?

DEFINITIONS

Fiscal Sponsor:

A **fiscal sponsor** (or fiscal agent) is a registered nonprofit that receives and allocates funds on behalf of another organization. Through a fiscal sponsor, a program that is not tax-exempt and/or is not incorporated can apply for and receive funding designated for nonprofits. An unincorporated organization must establish trust and good relations with a fiscal sponsor. The fiscal sponsor accepts responsibility for the program's use of funds in a charitable way.

Additional Resources

For more information on fiscal agents, see http://foundationcenter.org/get-started/faqs/html/fiscal_agent.html.

For more information on how your organization can qualify for lower postage rates, see www.usps.com/businessmail101/rates/nonprofit.htm.

For more information should your organization chooses to incorporate as a for-profit rather than a nonprofit, visit www.sba.gov.

Chapter 2 Starting a Nonprofit

2.1 Steps to Form a Nonprofit Corporation

Obtaining legal status as a nonprofit is a complex process. If you decide that obtaining nonprofit status is right for your organization, the basic steps for doing so are these.

Arrange for incorporators. Incorporators are legally responsible for creating the nonprofit and sign their names to document its creation. Incorporators should be like-minded people who share your concern with fostering the organization's mission. Most states require more than one incorporator or director. Incorporators may also serve on the board of directors, but they need to serve only until the first meeting. Also, an incorporator can create the nonprofit and be removed from that responsibility by the joint action of the newly designated directors.

TIPS

Incorporating Is a Complex Task

Hire an attorney to help you with the incorporation process. Some community legal clinics offer support to aspiring nonprofits.

Choose a name for the corporation. Choosing an appropriate name is an important decision. The name of your organization serves as a brand for its work and should convey its mission to the public clearly and concisely. Make sure the name you have chosen is not being used by another organization.

Draft articles of incorporation. Each state has a prescribed form for this document. Check with the office of your secretary of state, or the equivalent. Required information typically includes the name and purpose of the organization, the name and number of the relevant state law, the location of your organization's main offices, the agent of the corporation (i.e., the person to whom mail can be sent), and the names and addresses of incorporators. Incorporators must sign the document; some states require the signatures to be notarized. You do not have to incorporate in the state in which the organization conducts business. Like many for-profits, many nonprofits elect to incorporate in Delaware because of its liberal tax and corporate laws.

File the articles of incorporation and pay the prescribed fee. Send the articles of incorporation to the appropriate state office with all required paperwork and the fee the state has set.

Receive notice of acceptance and filing. Once the state agency has reviewed and approved the submitted articles of incorporation, it will send a certified copy of the articles, which serves as a certificate of incorporation. Once the certificate of incorporation is issued, your nonprofit corporation exists and can conduct business.

Draft bylaws for the corporation. Bylaws govern the internal affairs of an organization. They specify the number of board members, how they will be selected, how long they will serve, and how many will serve as officers. They also outline how the board will operate, the organization's financial and legal procedures, and the organization's mission. The state where your organization wants to incorporate may have guidelines for drafting bylaws. Remember that bylaws should be tailored to meet your organization's needs. They do not have to be submitted with the articles of incorporation, but the bylaws must be submitted with an organization's application for tax exemption. Given the potentially large impact of the bylaws on your organization, we strongly recommend that you have a lawyer draft them.

Apply for federal tax-exempt status. The IRS requires an Application for Recognition of Exemption (Form 1023) to gain federal tax exemption. IRS Form 1023 is long and contains many attachments.

An IRS determination letter will be sent to your organization when the federal agency has completed its review. IRS review of an application for tax exemption may take several weeks or months. You can check on the progress of the application at www.irs.gov. Donations to your organization made prior to approval may still be tax deductible in many circumstances.

Apply for state tax-exempt status. Some states require the application for exemption from state corporate taxes to accompany the certificate of incorporation, while other states decide on the basis of the IRS ruling.

Apply for nonprofit mailing status. Although not a mandatory step, you may want to apply for nonprofit mailing status. To apply, obtain a U.S. Postal Service application from the local postmaster and submit the completed application with the certificate of incorporation and filing fee.

DEFINITIONS

Articles of Incorporation:
Certificate of Incorporation:
Bylaws:

Articles of incorporation comprise the document filed with the state to become a nonprofit that includes basic information about an organization.

Certificate of incorporation is the document received from the state that certifies an organization as a nonprofit.

Bylaws are the rules that govern how an organization operates.

TIPS

Bylaws Have Considerable Organizational Impact

Include this kind of information in the bylaws:

- name and purpose of the organization;
- description of membership, including whether the organization has members, how people become members, and whether members are limited to elected directors;
- structure and operation of the board of directors, including the officers and board committees; and
- how bylaws can be amended.

Create the board of directors. The board of directors advises and oversees the work of the organization, using the bylaws as guidance. Section 2.2 discusses the role of the board and offers tips for selecting board members. Be sure to document all board meetings; an official corporate record book can be used to create a complete record of all board meetings and board actions. If incorporators are the original board members, they should elect additional or replacement members at the first meeting. Officers are usually elected at the first meeting and typically include a president, vice president, secretary, and treasurer. Officers should convene regular meetings of the board and draft and circulate minutes from the meetings.

Maintain records and file reports. Your nonprofit must file the appropriate federal and state income tax returns. Moreover, annual reports to the state attorney general on any fundraising activities typically must be filed.

2.2 Ways to Develop a Board of Directors

The board of directors is responsible for setting your organization's policy and ensuring its long-term sustainability. Make sure you attract people who believe in the organization's mission and who will follow through on their commitment to attend meetings and serve on committees. Attracting members with diverse skills is also helpful. Some of the board members should have expertise in youth development to help with programming decisions, while others should have legal, management, and/or financial backgrounds to provide assistance in these areas. The most important process is identifying the needs of the organization and recruiting board members to address those needs.

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In many organizations, board members play key roles in raising funds; this does not mean board members must donate large sums to the organization, but they may be expected to spend time on fundraising. Most organizations establish terms of service for board members. Consequently, your nonprofit should establish procedures for recruiting new and replacing nonreturning board members.

To recruit board members:

- seek individuals who support the organization's mission;
- establish a good record of service, finance, and management;
- ensure the bylaws clearly address the role of board members, including requirements of service, term of service, compensation, prohibited acts, liability and indemnification, and commitments to fundraising; and
- use current board members in recruitment efforts, because good people attract other good people.

Board members have several responsibilities, including a duty of care, a duty of loyalty, and a duty of obedience.

Duty of care. Members of your board of directors should be competent and able to fulfill their duties. They should attend board meetings regularly, show independent judgment when voting, be informed about organization business, delegate only to responsible persons, and follow up. Board members are not expected to exercise perfect judgment; they can be creative, take risks, and make mistakes without fear of being taken to court.

Duty of loyalty. The board of directors should be faithful to your organization. Board members must give their undivided allegiance to the organization when making decisions. They must avoid conflicts of interest, including family interests, and disclose personal interests in all decisions. The most common conflict of interest occurs when board members use a nonprofit organization's property for personal benefit or take personal advantage of information they obtain as board members. Board members can have business dealings with the organization, but all interactions should come under considerable scrutiny. At times members may recuse themselves from voting on organization matters that touch on personal interests.

Duty of obedience. Actions by the board of directors should adhere to your organization's mission. Board members must ensure your organization remains obedient to the purposes stated in the articles of incorporation. They are free to exercise reasonable judgment concerning how your organization should best fulfill its mission; however, donors should be confident their contributions will be used for the stated purposes.

TIPS

The Board Plays an Important Role

The board of directors:

- sets organizational policy;
- hires and fires the executive director; and
- guides organization activities.

The board should focus on the big picture. It should guide the policies and direction of the organization and should not get in involved in day-to-day operations. At the same time, the board must maintain its fiduciary responsibility to maintain the public trust.

Additional Resources

For more information on beginning steps in creating a nonprofit, see Foundation Center, *How to Start a Non-profit Organization* (New York, N.Y.: Foundation Center, 2006), at: http://foundationcenter.org/getstarted/faqs/html/starting_nonprofit.html.

For more information on operating a nonprofit, see G. Grobman, *Non-profit Handbook*, 4th ed. (Harrisburg, Pa.: White Hat Publications, 2005).

For tips and tools on running a nonprofit, see S. Hutton and F. Phillips, *Non-profits for Dummies*, 2nd ed. (Somerset, N.J.: Wiley Publishing, 2006).

For tips and tools on establishing a nonprofit organization, see Idealist.org., "Starting a Non-Profit" [2006], at: www.idealist.org/tools/starting-org.html.

For a list of IRS forms required over the life of a nonprofit, see www.irs.gov/charities/charitable/article/0,,id=122670,00.html.

For guidance on compliance issues for nonprofits, see Internal Revenue Service, U.S. Department of the Treasury, *Compliance Guide for 501(3)(c) Tax-Exempt Organizations* (Washington, D.C., 2003), at: www.irs.gov/pub/irs-pdf/p4221.pdf.

For guidance on tax issues for nonprofits, see Internal Revenue Service, U.S. Department of the Treasury, "Tax Information for Charities and Other Non-Profits" [2006], at: www.irs.gov/charities/index.html.

For a copy of Form 1023 (Application for Recognition of Exemption), see www.irs.gov/pub/irs-pdf/f1023.pdf. For a copy of instructions on completing this form, see www.irs.gov/pub/irs-pdf/i1023.pdf.

For state-specific information on articles of incorporation, see www.irs.gov/charities/article/0,,id=129028,00.html.

For information and resources on building effective boards, see www.boardsource.org.

Chapter 3

Building a Financial Management System

Your financial management system is all of the people, policies and procedures that your organization uses to maintain control of its finances and ensure that those finances are used responsibly to further its mission. Your youth-serving organization relies on financial management systems both for day-to-day operations and long-term planning. Proper financial management sustains your program, enabling it to stay in operation and meet your obligations to funders and communities.

3.1 Elements of Financial Management Systems

Effective financial management systems involve much more than just paying the staff and keeping on top of the bills. Good systems have seven essential elements: a clear mission and key results, programming, budgeting, financial controls, accounting, financial reporting and review, and auditing.

A clear mission and key results. Financial management systems exist to support your organization's goals, objectives, and operations. They enable the staff, board of directors, and volunteers to achieve desired outcomes. Before a single spreadsheet is created, however, your organization must express a clear mission and determine key results. All decisions, financial and otherwise, should be based on that mission and those results.

Programming. A financial management system should reflect and support the programs and activities of the organization. If you are engaged in a number of programs and receive support from a number of funders, then you need to budget, manage, and account for funds both separately and for the organization as a whole.

Budgeting. Budgeting is a deliberate, ongoing process to determine how your organization will spend money to attain specific short- and long-term goals within a given timeframe. It is also a tool for planning, monitoring costs and making decisions. Budgeting is discussed in depth in Chapter 5.

Financial controls. Internal financial controls promote and protect sound financial management practices. They provide a reasonable assurance that your organization's resources are safeguarded from fraud, waste, and abuse as well as ensure that your plans and policies are properly implemented. Financial controls are covered in Chapter 6.

Accounting. This process records and keeps track of all financial transactions that occur within your organization. A good accounting system records, reviews, summarizes, and reports all financial activities accurately and on a timely basis. Accounting is reviewed in Chapter 4.

Financial reporting and review. Financial reporting is a process of summarizing all financial transactions—all revenue coming in and all expenditures going out—for a given period. It is a tool to support your internal decision-making. It is also a means to meet external requirements from, for example, funders and the government. Reporting is discussed in Chapter 8.

Auditing. Auditing tests the accuracy and completeness of information presented in financial statements. Usually completed by an independent outside entity, a successful audit proves the integrity of your organization's financial records. Audit requirements vary among states; smaller organizations may not be required to conduct an audit. Auditing is discussed in Chapter 9.

Factors Affecting Financial Management Systems

No two programs are exactly alike, so financial management systems should be designed to suit your organization's needs. Base your financial management systems on:

- the size and complexity of your organization;
- how long your organization has been operating;
- the nature of the programs and services your organization offers; and
- the skill sets of your staff.

3.2 Role of a Financial Manager

A good financial manager will develop and use tools to manage the financial responsibilities of your organization and support the work of your program managers. Your financial manager should:

- design processes and policies that support the work of program managers;
- coordinate and sometimes lead financial planning, budgeting, and monitoring;
- determine the appropriate amount of resources your program needs;
- manage costs, including avoiding or reducing excessive costs;
- manage working capital (for example, revenue minus expenses) and cash flow;
- efficiently allocate funds to specific assets and activities (for example., investments);
- control risk; and
- support fundraising and grants management.

If you are the executive director of a small organization, you may also be the financial manager. As organizational size increases, a more effective practice is to employ a dedicated financial manager, enabling you to focus on programming and fundraising. In addition, having two managers—typically you and the director of finance and admnistration—scrutinize the finances improves both the accuracy and the integrity of financial management systems.

A good financial manager will develop and use tools to manage the financial responsibilities of your organization and support the work of your program managers.

DEFINITIONS

Cash Flow:

Cash flow is the pattern of income and expenditures over time. Plan when you need to pay out funds according to when you receive funds so your organization can maintain a positive cash flow.

TIPS

Financial Management Systems Should Support Decisionmaking

Design your financial management systems to provide information that can help you make important decisions, such as:

- whether to expand or contract programming;
- whether to rent or purchase facilities or equipment; and
- where to focus fundraising activities.

3.3 Goals of Financial Management Systems

Good financial management systems focus on results, support programming, ensure accountability, support decisionmaking, and monitor financial performance. These systems must also be appropriate for the organization's scale.

Focus on results. Every system element (e.g., reporting, budgeting, accounting, and auditing) should support your organization's goals. Financial management structures should help you and your managers understand whether your organization is allocating resources effectively to achieve its mission.

Support programming. Good lead finance managers know they exist to support the program. Program managers in small youth-serving organizations face many challenges in their day-to-day work. Your organization's financial management systems should help them focus on the important tasks they must perform and not distract them with unnecessary burdens.

Ensure accountability. At the same time that the financial management systems should be "user-friendly" for the program staff, the systems must also ensure your board of directors and staff do not violate—intentionally or unintentionally—legal restrictions and ethical standards. Your financial management systems should include policies and processes that create internal accountability.

Support decisionmaking. Financial management systems should provide information for you and your managers to make smart, informed decisions. The systems should also enable your program leaders to demonstrate to public- and private-sector funders that your organization has the capacity to use funding wisely.

Monitor financial performance. Your financial management systems should help ensure your organization is financially sound (for example, is not spending more than it takes in, has sufficient reserves, and is operating efficiently). Ideally, your lead finance manager uses financial information to anticipate problems before they become crises.

Be appropriate for the organization's scale. Given the limited resources that most organizations have for infrastructure, you should tailor the scope of your financial management systems to the needs of your organization. As the lead finance manager sets up the financial structures, he or she should consider:

- the complexity of reporting requirements;
- the number of financial transactions (for example, deposits made and checks written) in a given period;
- the complexity of the chart of accounts; and
- the number of staff.

These and other factors will drive the size and complexity of the financial management systems. The systems must meet your organization's needs for the present and the next few years, but no longer than that. A lead finance manager should expect that changes in technology and generally accepted accounting principles will routinely make the existing systems obsolete. For this reason, resist the urge to overspend on state-of-the-art systems.

3.4 Seven Signs of Financial Health

Your organization can be considered financially healthy if [1]:

- it has enough income to ensure stable programming;
- it has access to cash or can raise cash if a shortfall occurs;
- it uses realistic income projections and presents realistic program and service delivery costs in its spending plan;
- the costs of programs do not exceed their assets (the programs operate on a modest surplus);
- it has a "rainy day fund" (a reserve of cash on hand) to finance growth and cover cash shortfalls;
- it can reduce operating costs or use a rainy day fund to cover a deficit; and
- the board of directors and executive managers hold themselves responsible for the organization's financial stability and integrity.

Your organization is more likely to be financially healthy if the board of directors and executive managers hold themselves responsible for the organization's financial stability and integrity.

Almost every youth-serving nonprofit experiences an occasional period of financial discomfort. However, if you find the organization is consistently at risk of closing its doors, you and your lead finance manager should review the signs of financial health and identify the weaknesses in your organization's practices. For more information on financial sustainability, visit The Finance Project's website at www.financeproject.org.

Additional Resources

For more information on fiscal operation of a nonprofit, see National Council of Non-Profit Organizations, *Sample Fiscal Operation and Policy Manual* (Washington, D.C.: National Council of Non-Profit Organizations, April 2004), at: www.ncna.org/_uploads/documents/live/Sample_Fiscal_Operations_Policy.doc.

For more information on raising funds for nonprofits, see Dorothy A. Johnson Center for Philanthropy and Non-profit Leadership, "Non-profit Good Practice Guide: Fundraising and Financial Stability" [2006], at: www.npgoodpractice.org/Financial/.

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1 LarsonAllen Public Service Group

Chapter 4

Structuring the Accounting System

Accounting systems track and record all of an organization's financial data and transactions. An efficient accounting system provides financial statements that summarize financial activities on a regular basis and in a timely fashion. Well-maintained accounting records also help you analyze and summarize the real costs of activities, make the best use of resources, and ensure resource allocation matches your organization's priorities.

4.1 Financial Accounting

Your organization must have a financial accounting system. This includes tracking expenses, revenues, assets, and liabilities. Reports produced from this system typically are subject to external verification. The financial accounting system aims to ensure that financial data and transactions are properly entered into accounting records and that the financial reports necessary for management are accurate and timely.

A financial accounting system is composed of accounting records (checkbooks, journals, ledgers, etc.) and processes and procedures assigned to staff, volunteers, and/or outside professionals. Traditionally, a financial accounting system includes a chart of accounts, a general ledger, journals, a checkbook, and an accounting procedures manual.

Chart of accounts. The chart of accounts lists each item the accounting system tracks. Section 4.2 provides more information on this important document.

General ledger. This document organizes information by account. The chart of accounts acts as the contents page for the general ledger. In automated systems, summary totals from all journals are immediately entered into the general ledger, which maintains a year-to-date balance for each account.

DEFINITIONS

Posting:

Posting is the process of transferring information from journals to the general ledger.

Journals. Automated systems seamlessly record all accounting transactions before they are entered into the general ledger. Journals, also called books of entry, organize information chronologically and by transaction type. Typically, three primary journals are maintained within the automated system, though they may not be displayed or may be combined.

- A **cash disbursement journal** is a chronological record of all checks that are written and is categorized using the chart of accounts (for example, all payments related to operations).
- A **cash receipts journal** is a chronological record of all deposits and is also categorized using the chart of accounts (for example, grants, contracts, publication sales, and interest).
- A **general journal** is a record of all transactions that do not pass through the checkbook, including noncash transactions and corrections to previous journal entries (for example, depreciation, deferred rent, and other outstanding obligations).

Checkbook. For very small organizations, a checkbook can serve as a combined ledger and journal. If your organization has paid staff, it will need a more sophisticated system.

Accounting procedures manual. This important document lists all procedures for handling financial transactions. The manual can be a simple description of how your organization's financial functions are handled and who is responsible for what. Clearly outlining accounting procedures will avoid confusion and help keep things running smoothly, especially during times of staff turnover.

Clearly outlining accounting procedures will avoid confusion and help keep things running smoothly, especially during times of staff turnover.

4.2 Chart of Accounts

The chart of accounts lists each account that is tracked and is the heart of a financial accounting system. Your organization's chart of accounts should correlate to the categories in its budget so you can easily produce budget-to-actual statements. Each account is assigned an identifying number for use within the accounting system. Generally, the chart of accounts is divided into six major accounts—assets, liabilities, net assets (or fund balances), revenues, expenses, and functions of your organization—and includes a brief description of each account. (See page 32 for a sample chart of accounts.)

Assets. This account lists tangible items that your organization has as resources, including cash, property, equipment, and accounts receivable. Assets are usually presented in order of liquidity. Cash and other assets that are easily converted to cash are listed first; fixed assets, such as property and equipment, are listed last.

Liabilities. This account lists obligations that are due to creditors, such as loans and accounts payable. Current liabilities (usually those that are due within the next year) are usually listed first, followed by long-term liabilities.

Net assets (or fund balances). This account lists the balance remaining after liabilities are subtracted from assets. Net assets reflect an organization's financial worth. If your organization only receives unrestricted funds, it will have only one net assets account; if it also receives restricted funds, it will have more than one net assets account.

Revenues. This account lists contributions, service revenue, rental income, grant and contract revenue, and interest and dividend income. (Revenues are also called income.)

Expenses. This account lists the amounts paid for labor, goods, and services, such as rent, salaries, and utilities. Expenses are used-up assets.

Functions of the organization. This account lists your organization's critical cost centers or program areas. It may be displayed on a different axis than the other chart of account categories. Often the other categories will be shown as rows and the functions (for example, cost centers or restricted fund programs) will be displayed as columns.

TIPS

Digits Reveal Key Information

Make sure the digits in the chart of accounts designate specific segments, such as expense (four digits), department (three digits), and location (two digits). For example, chart of account code 5010-100-01 could signify salaries-afterschool program-main building.

Remember that the chart of accounts is continually changing. A current chart of accounts is necessary to ensure proper account coding. You should periodically review and update the charts of account to ensure it accurately reflects the relevant categories of revenue and expenditures for your organization. Ideally, the chart of accounts would only be modified during the budget process. All changes complicate comparisons with previous years, so the changes should be limited. Everyone who has budgetary responsibility or the authority to approve and code expenditures should have an updated copy of the chart of accounts.

Questions to Consider When Creating a Chart of Accounts

- **What financial decisions and assessments are made on a regular basis?** The response to this question can guide you in deciding what information you need to differentiate. For example, if an organization earns fees for some of its services, should all the fees be combined into one account or should information on fees from each type of activity be available?
- **What reports are needed?** Consider what reports are needed to meet external requirements and what reports will help in making internal management decisions. Some reports should be consolidated; not everyone needs to see all the details.
- **What level of detail is needed?** Determine the highest and lowest levels of detail needed from the financial records. Make sure to consider how managers will use the information that is recorded. Too much detail defeats the purpose of categorizing information into accounts. Financial details should be linked to behaviors; managers should be able to see information at a level where they can manage it.
- **What is the capacity for tracking financial information?** This capacity includes your bookkeeper's ability and availability to manage complex information and your organization's ability to interpret it.

4.3 Financial Accounting Methods

You and your lead financial manager will have to choose whether to base the financial system on a cash or accrual basis.

Cash accounting. This method recognizes and records all revenue and expense transactions when cash is received or deposited. Expenses are recorded in the accounting period the bills are paid. A cash accounting system is really a running tally of cash received and expenses paid. Small organizations typically use cash accounting, and many newer organizations find cash accounting to be easier to administer.

Accrual accounting. This method records income in the accounting period in which it is earned, regardless of when the cash is received. Expenses are recorded as they are owed, instead of when they are paid. This method provides a more meaningful record of an organization's fiscal status, and it is recommended practice according to "generally accepted accounting principles" or GAAP.

You and your lead finance manager should discuss the implications of choosing one practice over another with an experienced accountant. The system chosen will impact day-to-day operations as well as tax preparation and annual reporting requirements.

In addition to deciding whether to use a cash or accrual accounting system, you may choose to use one or more of these systems to complement the primary systems: fund accounting, results-based accounting, and/or cost accounting.

Fund accounting. For some types of grants or contracts, you will also have to account separately for certain funds. This is referred to as fund accounting and can happen with either a cash or accrual system. Government-funded nonprofits usually use this method to report on government grants.

TIPS

Cost Accounting Takes Time But Is Worthwhile

Recognize that developing a cost accounting system is a long-term goal. Such a system has the potential to offer enormous benefits, but its development will not occur overnight. A cost accounting system enables an organization to:

- demonstrate cost-effectiveness;
- understand and monitor resource flows;
- make optimal resource allocation and program choices;
- communicate policy-relevant data to key stakeholders; and
- produce external reports on the costs and benefits of the organization's work.

Results-based accounting. A growing number of nonprofit organizations are implementing results-based accounting systems. These systems track expenses for different services and/or activities by the results they aim to achieve. This is particularly helpful if your organization is interested in understanding how investments in various strategies and activities help meet stated goals. If an expenditure is related to more than one result, then you must determine what percentage of the costs is attributable to each result.

For example, the salary expense for a youth development program is coded as 60 percent for children and youth succeeding in school and 40 percent for youth ready to enter the workforce. Following is an example of results-based accounting for this scenario.

Result	Service	Type of Expenditure	Amount
Children and youth succeeding in school	Afterschool program	Staff salary	$30,000
Youth ready to enter the workforce	Youth apprenticeship program	Staff salary	$20,000

Cost accounting. Cost accounting is a process for measuring and analyzing information on the costs of your organization's services. This process aims to determine the correlation between services provided by your organization and the actual costs of those services. It builds on the information that financial accounting provides and can be used to help understand the effectiveness of various programs and activities. Your youth program may choose to implement a cost accounting system to augment its financial accounting system. A cost accounting system is necessary to implement a results-based accounting system.

A cost accounting system is composed of the same accounting records and procedures as a financial accounting system. However, in a cost accounting system, financial data is integrated with service and outcome data from your organization's activities. An effective cost accounting system provides information on organization and staff capacity. It also provides data on revenue, costs, services to clients, and client and community outcomes.

4.4 Accounting Software

Your organization should use some form of accounting software. An accounting software package will increase efficiency and lower costs by decreasing staff time spent on data entry and report production. It can give reporting greater accuracy by minimizing human errors—though coding errors are still possible—and providing checks to verify entries and balances. By eliminating the distance between data entry and report production, accounting software can generate reports very quickly. This software can also enhance systems for verifying data, including avoiding duplicate coding and identifying incorrect codes, erroneous dates, and inappropriate postings. Moreover, accounting software provides enhanced security measures to prevent changes to posted transactions or unauthorized entry into the accounting system. Most software allows for user restrictions. For example, the person who enters accounts payables is not allowed to write checks.

Making the Most of Accounting Software

To take advantage of accounting software, your organization must have access to qualified staff, hardware, security, backup, and accurate balances.

- **Qualified staff.** Accounting software requires trained staff to enter data, verify accuracy, and manage technical issues. However, if your organization is already keeping some accounts, it already has sufficient expertise for the baseline accounting packages available. The basic accounting software packages are quite simple to use.
- **Hardware.** Some accounting software requires large amounts of computer memory and computer speed, but the basic versions can run on most current operating systems. A computer network is also needed if more than one computer will be used to enter data or generate reports.
- **Security.** To use accounting software, adequate measures must be taken to secure confidential information. This includes digital security via password protection and antivirus and firewall software. It also includes physical security, such as a lockable office. The software should be placed on a network hard drive that has limited access.
- **Backup.** Use of accounting software requires the ability to back up data entries on a daily or weekly basis. Again, basic inexpensive software can create backups to another hard drive or a website. This feature will quickly pay for itself when the inevitable happens and the data is lost or corrupted.
- **Accurate balances.** To get good results from accounting software, the program must start out with accurate balances; otherwise, it is garbage in, garbage out.

TIPS

Be Prepared For a Disaster

Whether caused by storms, theft, fire or simple hard drive failure, have a plan for recovering your lost data. Make copies of essential information on a regular basis and store them off-site.

To choose accounting software, you must first assess what your organization wants from the package. Then, identify the capabilities of the available software and compare how those fit your organization's needs and functions. Many sources of information on software packages exist. In addition to consulting product literature and local dealers, contact other nonprofits, accountants, and current users for their opinions and experiences. Consider the following factors to help you determine the most appropriate software for your organization.

- **Cost.** What is the total cost of the accounting software package, including software, licensing, hardware upgrades, training, and ongoing support?
- **Ease of use.** How user-friendly or intuitive is the software? How long would it take to train your staff to use the software?
- **Technical support of vendor.** What support is provided? How is it delivered (e.g., in person or via phone)? What is the cost of support?
- **Customization.** How can the software be adapted to fit your organization's needs and functions? Do changes require vendor assistance? Does vendor assistance cost extra?
- **Account code flexibility.** Are limits placed on the types and number of account codes that can be created? Can the software track by fund, department, program, and/or result?
- **Controls.** To what degree can individual access to discrete accounting activities be controlled through the software?
- **Reporting capabilities.** What types of reports can be produced? How can they be tailored (level of detail, timeframe, etc.)? Can data be exported to Excel or another program?
- **Financial Accounting Standards Board requirements.** Does the software comply with all board requirements? Does it comply with reporting requirements from funders?
- **Hyperlink and imaging.** Does the software enable a user to click on data and track it back to its source? Can users scan in documents (invoices, purchase orders, etc.) to link them to data?

When preparing to select a new accounting software package, you may choose to formulate a technology action plan that helps ensure your organization's technology needs are considered in conjunction with decisions on accounting software. Complex accounting systems may require more user training and support than they justify.

Formulating a Technology Action Plan

The following steps can help guide the development of a technology action plan.

- **Form a technology committee.** Determine who will be responsible for preparing the needs assessment and software review. Include staff and board members with technical expertise and interest.
- **Analyze existing system and accounting needs.** Have the committee conduct a thorough assessment of the various software packages' technical capabilities—speed of system, amount of memory, security measures, etc.—as well as review the organization's accounting needs.
- **Develop a selection strategy.** Based on the review of capabilities and needs, develop a strategy to analyze software packages and report recommendations back to the board of directors for their selection.
- **Implement.** Expect and allow time for implementation, work disruptions, data transfers, training, and other startup issues.
- **Follow up.** Is everything working the way the committee intended? What adjustments have been necessary? What costs were not anticipated?

Additional Resources

For more information on the Financial Accounting Standards Board, visit www.fasb.org.

For more information on accounting software packages, see Ted Needleman, "Special Report: Accounting Software Round-Up," *The NonProfit Times*, 1 January 2005, at: www.nptimes.com/Jan05/sr1.html.

For more information on accounting in nonprofits, see W. Ruppel, *Not-for-Profit Accounting Made Easy* (New York, N.Y.: John Wiley and Sons, 2002).

Sample Chart of Accounts

Account Number	Account Title	Account Description
General Ledger — Assets		
1010	Petty Cash	
1020	Cash Adjustment Account	
1030	Cash, Operating	
1040	Cash, Payroll	
1050	Cash, Savings	
1110	Investment—Money Market	
1210	Accounts Receivable	
1220	Grants Receivable—Federal	
1230	Grants Receivable—State	
1240	Grants Receivable—Private	
1270	Contributions Receivable	
1310	Prepaid Expenses	
1320	Prepaid Insurance	
1330	Prepaid Postage	
1390	Other Current Assets	
1610	Furniture and Fixtures	
1620	Furniture—Off site	
1630	Vehicles	
1640	Computer Equipment	
1660	Computer Software	
1670	Equipment	
1710	Leasehold Improvements	
1720	Accumulated Depreciation	
1810	Deposits	
1820	Deferred Charges	
1830	Other Assets	
General Ledger — Liabilities		
2010	Bank Line of Credit	
2020	Other Notes Payable	
2030	Accounts Payable	
2040	Other Current Liabilities	
2110	Federal Taxes Withheld	
2120	State Taxes Withheld	
2130	Local Payroll Taxes Withheld	
2140	State Unemployment Taxes Withheld	
2150	Workers Compensation Payable	
2160	Disability Tax Payable	
2170	Health Insurance Payable	
2180	Retirement Plan Payable	
2210	Accrued Wages	
2220	Accrued Vacation	
2230	Accrued Lease	
2240	Deferred Revenue	
General Ledger — Net Assets		
3010	Net Assets	

Sample Chart of Accounts

Account Number	Account Title	Account Description
General Ledger — Revenue		
4010	Federal Grants	
4020	State Grants	
4030	Contributions—Individual	
4040	Contributions—Corporate	
4050	Flexible Funds	
4060	Fund Raisers	
4070	Participant Fees	
4080	Interest Income	
4090	Other Income	
General Ledger — Expenses		
5010	Salaries and Wages	
5020	Salaries and Wages—Bonuses	
5030	Contracted Services	
5040	FICA/Medicare Payroll Tax	
5050	State Unemployment Tax	
5060	Disability Tax	
5070	Workmen's Compensation	
5080	Health/Life Insurance	
5090	Retirement Plan	
5100	Leave	
5110	Other Benefits	
5210	Advertising	
5220	Automobile Expense	
5230	Bank Charges	
5240	Board Expenses	
5260	Copy Expense	
5270	Depreciation	
5310	Insurance Expense	
5320	Interest Expense	
5330	Internet Expense	
5340	Licenses and Fees	
5350	Maintenance and Repairs—Building	
5360	Maintenance and Repairs—Equipment	
5370	Other Services	
5410	Professional Fees	
5420	Supplies—Office	
5430	Supplies—Program	
5440	Telephone	
5450	Travel	
5460	Utilities	
5510	Rent	
5520	Meetings and Seminars	
5530	Payroll service	

Chapter 5 Creating and Using Budgets

A good budget converts your organization's mission and vision into a concrete, actionable plan. A well-constructed and monitored budget will enable your youth-serving organization to foresee potential financial deficits; adjust plans, activities, and spending accordingly; spend dollars more cost-effectively; and, above all, work toward accomplishing its mission and vision.

5.1 Budget Uses

The budget serves several purposes. It is a tool for planning as well as a tool for monitoring. Budgeting must also be considered an ongoing process.

A tool for planning. A budget is a plan of action that enables your organization to express its goals and objectives in financial terms. Budget planning provides an opportunity to establish your program goals, objectives, and priorities and link them to monetary figures. Attaining your organization's goals and objectives will be more likely if its budget is planned well. In addition, budgets serve a practical role by preauthorizing certain expenses.

A tool for monitoring. A budget also serves as a tool to monitor financial activities. By monitoring current spending levels and comparing those levels with the amounts set in the original budget, you can determine whether what you planned is being achieved. If significant deviations are occurring between planned and actual spending, then you can take actions to help get back on track.

A good budget converts your organization's mission and vision into a concrete, actionable plan.

An ongoing process. Budgeting does not occur in a vacuum or for only a limited period. Financial activities must be constantly monitored, so budgeting must be a deliberate, ongoing process requiring continuous attention from you and your lead finance manager.

5.2 Types of Budgets

Your organization can use several types of budgets, including operating budgets, cash flow budgets, opportunity budgets, and capital budgets, to plan for and track revenues and expenses. Most organizations use more than one type of budget, typically employing an operating budget and a cash flow budget on an ongoing basis and an opportunity budget and a capital budget as needed.

Operating budgets. Your organization needs an operating budget. Operating budgets identify expected expenses (staff salaries, supplies, etc.) as well as revenue (grants, contributions, income from fees, etc.) for the current fiscal year. Section 4.4 provides more information on operating budgets.

Cash flow budgets. Cash flow budgets track how much money you will spend and receive on a monthly basis (see the Sample Cash Flow Budget on page 50). Monthly projections enable you to anticipate times when funding shortages are likely, giving you an opportunity to develop strategies to accommodate those shortages before they happen. If a surplus occurs, a cash flow budget enables you to determine the best way to use the additional funds. Cash flow budgets can help track accounts receivable, triggering invoices, reports, or other deliverables required to receive scheduled payments on grants and contracts.

Opportunity budgets. Opportunity budgets analyze possibilities for your organization to expand and take advantage of new opportunities. Ideally, opportunity budgets are used in conjunction with other budgets and help you evaluate the options available to expand your business.

Capital budgets. If your organization is facing a large expenditure, such as purchasing a building or paying for a renovation, a capital budget that evaluates the cost of long-term investments and projects can be a useful tool.

PITFALLS

The Budgeting Process Can Be Overwhelming

Don't let the budgeting process overwhelm your organization. Create a fiscal management team to share responsibility among board members and staff. Keep in mind, however, that budgets often contain sensitive information on salaries and staffing patterns. Not everyone in your organization should have access to all budget information.

5.3 The Budget Process

Regardless of the type of budget your organization uses, the budgeting process can be demanding and emotional. To make budgeting as straightforward as possible, follow these steps (see the Budgeting Checklist on page 46).

- **Identify Stakeholders.** It's important to identify the people who will be impacted by your budget. Make a list of the people who should have a role in the process, be it approving the budget, providing input or simply being kept informed. Board, staff members, funders, community members and clientele are among the possible participants. Be sure to manage expectations about the nature of their participation; not every group can have the right to approve the budget.

- **Craft your budgeting policies and procedures.** Before the budgeting process begins, craft your budget policies and procedures and describe the content and format of the budget. These policies and procedures should also address who has input in creating the budget, how their input is provided, and who has the authority to approve the budget.

- **Set a budget calendar.** The budget calendar is an annual timeline of your organization's budget activities. It clearly outlines when specific tasks will be undertaken and which staff or board members will be responsible for various tasks (taxes, grant reports, etc.). The budget calendar helps guide you and your staff to ensure your organization is on schedule in performing its fiscal responsibilities.

- **Achieve consensus on results and strategies.** The budget should be driven by what your organization wants to achieve during the next fiscal year. Before resources are arranged and deployed, your organization and budget team must first achieve consensus on goals and strategies. Decisions on whether to, for example, expand or contract the program, change the target client population, or collaborate with other organizations will impact the budget and need to be made before budgets are created. Invite key team members to participate in the process. By focusing on buy-in, good budgeting balances the inefficiencies associated with an unwieldy process against the efficiencies gained during implementation.

- **Project revenue and estimate expenses.** Projecting how much revenue will come into your organization during the fiscal year and estimating how much it will spend on program operations are important steps. At this point in the process, you should closely examine both spoken and unspoken assumptions. Revenue sources or expenses that are taken for granted can lead to unpleasant surprises. Considering worst-case scenarios can be helpful. Typically, revenue is difficult to project. You should avoid committing to expenses until your organization is fairly certain about its revenue stream(s). Sections 5.5 and 5.6 provide further information on these topics.
- **Analyze cash flow needs.** Income may not always arrive in a regular and timely fashion. Developing a cash flow budget provides a clear picture of when funds are expected and when expenses will occur. This type of budget reveals any periods of shortfall. Section 5.8 provides information for dealing with cash shortfalls.
- **Approve and implement the budget.** The budget policies identify who has the authority to approve the budget. Often the board of directors votes on the final annual budget. Once approved, the budget plans are ready to be put into action.
- **Compare actual expenditures with budgeted amounts.** Budgeting is an ongoing process, not a one-shot deal. As your organization implements its budget, you and your lead finance manager should monitor actual expenditures and compare them with budgeted amounts on no less than a quarterly basis. Some organizations review budgets on a monthly basis or even more often.
- **Revise the budget.** You should update budget projections periodically based on analysis of new information. Sometimes revisions are minor and do not require changes in program operation. However, if estimates prove to be dramatically off, you may need to make major operating changes to ensure expenditures do not exceed revenues over the fiscal year. Many organizations develop an internal budget at the beginning of the fiscal year and revise it midway through the year to reflect any changes in circumstances.
- **Follow up with stakeholders.** As your organization moves through the process there will inevitably be changes to the budget. Once you've engaged your stakeholders, keep them informed of the organization's progress, particularly if there are significant adjustments from the original direction.

DEFINITIONS

Cost Center:

A **cost center** is a segment of your organization in which costs can be segregated. Cost centers are established in large organizations to identify responsibility and control costs. For example, in a multiservice organization, the afterschool program and day care programs might be separate cost centers.

5.4 Operating Budgets

Your organization needs to have an operating budget. Operating budgets include estimated revenue and expenses for the current fiscal year, and they can be done at the project or organization level. Project budgets reflect the costs and revenue associated with a specific program, activity, or cost center (see the Sample Operating Budget by Project on page 51). They are developed both for direct services and for various other functions (for example, coordination and evaluation). After the project budgets have been created, these individual budgets can be rolled together to create your organization budget. Organization operating budgets reflect the total revenue and expenses of your organization.

Operating budgets, at both the project and organization level, typically include projected income and revenues, projected expenses by categories and subcategories, projected expenses by line item, and budget narratives.

- **Projected income.** Provides estimates of all incoming funds, by sources and amounts.
- **Projected expenses by categories and subcategories.** Provides a summary of expenses, by various account categories and subcategories (for example, salaries and benefits). Subtotals are given for each category. As part of the buy-in process, you may find it helpful to assign responsible team members the task of projecting specific expense areas, such as travel or conference attendance.
- **Projected expenses by line item.** These projections estimate expenses within specific line items (for example, individual employee salaries) of each account category.
- **Budget narratives.** These narratives explain and justify your budget figures, including how specific income or costs were calculated. Budget narratives are also used to explain significant increases or decreases from the past year's budgeted amounts.
- **Budget comparison.** If your organization has at least several years of operating history, the budget should be placed in context. The current budget should be compared with the prior years' budgets and, especially, recent actual performance. Changes in program goals should explain any significant differences.

TIPS

Budget Organization Is Key

Make sure the budget is organized in the same way as the chart of accounts used for financial recordkeeping. This will make it easier to track your actual progress against the budget over the course of the year.

5.5 Types of Revenue

Understanding the different requirements of various sources of revenue will help your budget team determine how to spend those funds most efficiently.

Unrestricted funds. These funds can be used for any purpose at your organization's discretion and assigned to any budget category or line item. Unrestricted funds are flexible and can be used for services or activities not covered by other funding.

Restricted funds. Restricted funds are grants or contracts that come with limits or guidelines from the funding source on how the funds can be used. The funding agency or grant may specify that funds be earmarked for specific purposes, only used to serve people who meet specific eligibility requirements, and/or require the use of a specific budget category or line item. For example, a family foundation in Chicago may require that funds are used to serve only City of Chicago residents. Restricted funds may also require an audit to demonstrate compliance with certain regulations. All requirements—reporting, delivery of products and services, invoicing procedures, etc.—should be clearly outlined in the grant or contract agreement and should be included in your organization's budget calendar.

Asset-generated income. Asset-generated income comes from your existing financial resources. Sources most commonly include short-term investment income and interest-bearing bank accounts.

Contributions requiring a match. Some grants or contracts require matching funds. Allowable sources for the match are usually stipulated (for example, public or private sources) along with guidelines about cash and in-kind contributions. The grant or contract may also specify how the matching funds must be used. Finally, some grants or contracts may require, for reporting purposes, a separate line item in the budget to track matching funds.

Noncash or in-kind contributions. Noncash or in-kind contributions are nonmonetary supports, such as goods, services, facilities, or equipment. Your lead finance manager should clearly outline a method to determine and document the value of noncash contributions.

TIPS

Restricted Funds Mean Just That

Make sure your organization's program managers who are using restricted funds understand all the restrictions. For example, if a grant restricts the use of the funds to serve residents of a certain neighborhood, the program manager needs to ensure enrollment is limited to that neighborhood's residents or use other funds to serve nonresidents.

TIPS

A Contingency Budget Is Needed If Funding Is Uncertain

Develop a contingency budget if your organization must depend on uncertain funding sources. For example, if fees for service comprise an important source of revenue, it is a good idea to create revenue benchmarks during the year to monitor income. That way your organization can anticipate shortfalls.

Income from trade or business activities. This income derives from fees for service or sales of goods. It is generated from an activity carried out by your nonprofit in accordance with its mission. If youth in your afterschool program make and sell art as part of the regular programming, for example, that is considered business income.

Unrelated business income. This income, also referred to as UBI, is income generated through activities not related to your nonprofit's mission. For example, your youth program may have UBI from renting out space or equipment when the program is not using that space or equipment. If income from UBI activities is more than $1,000 per year, it is subject to corporate income taxes. No limit exists for how much UBI your organization can earn, but it should be used to support work associated with your mission.

5.6 How to Project Revenue

When developing an operating budget, your lead financial manager should project the amount of money the organization will receive during the fiscal year. This enables your budget team to know whether there is adequate funding to cover all programs and activities or whether additional funding is required. Projecting revenues for the coming fiscal year can be a challenging prospect. If your organization is largely reliant on discretionary grants for funding, it's not possible to know for sure which proposals will be funded and which will be declined. However, there are things financial leaders can do to better understand the revenue outlook.

Scan the environment. Significant changes in the local, state or national economy as well as changes in political leadership can have a real impact on your organization's revenue streams. Good financial leaders pay attention to transformations in their operating environment that might affect their funding. Forewarned is forearmed.

Cultivate relationships with key information sources. Get to know the people who know about your organization's funding streams. For example, if the majority of your organization's budget is funding from the state, speak with people who work inside the state budgeting process. Your local representative to the state legislature is a good place to start.

Maintain a current understanding of funder priorities. Whether public or private, funding sources periodically change their priorities. Sometimes this is the result of a change of leadership and sometimes it is simply an alteration of strategy. Keep in touch with the program officer for your organization's significant funding streams to hear about possible adjustments. In addition, watch where those funders are making other investments; these new grants can provide clues to their future strategic direction.

5.7 Types of Expenses

Your organization needs to include both direct and indirect costs in its budget. Direct costs are specific costs associated with operating programs and sustaining the organization; they can be separated into project or program service delivery expenses or fundraising expenses, depending on what type of activities they support. Expenses that support your organization's general operation are called indirect costs or overhead.

Project or program expenses. These are direct costs related to a specific project or program activity in your organization. Service delivery expenses may include costs for staff salaries and project- or program-specific supplies and equipment, printing, and evaluation.

Fundraising expenses. These are direct costs related to specific functions or activities aimed at building and sustaining your organization. Fundraising expenses include costs associated with board development, grant writing, sustainability planning, collaboration and partnership-building, and fundraising data systems.

Overhead expenses. These are indirect costs that are related to the general management activities of your organization, rather than the direct provision of services. Overhead expenses include salaries for management and administration and costs for rent, telephone, and general office supplies and equipment. Chapter 7 addresses allocating overhead in further detail.

5.8 How to Estimate Expenses

This phase of the budgeting process enables your organization to determine the total costs of various programs and activities. When you are projecting

TIPS

Estimating Expenses Well Is Not Hard

Know that budgeting usually becomes easier over time. For example, your past year's budget is a great tool for creating this year's budget. Use the past year's expenses as a baseline, make appropriate adjustments (for example, new expenses because of programming changes), and account for potential cost increases. Your previous budgets also are a good guide for cash flow information, enabling your organization to plan for temporary shortages. You can use the most recent estimated annual rate of inflation as a general rule of thumb for estimating some cost increases. Discussing potential increases with your larger vendors (for example, landlords, health insurers, and utility companies) can also be helpful.

expenses, consider factors such as fringe benefits, salaries and wages, other operating costs, and costs of generating future income. Moreover, understand that sometimes you may be required to carry funds forward into a new fiscal year, such as when the funds are restricted and must be used for a project that does not align with the fiscal year. What may look like a surplus may just be an obligation that has not been accounted for yet.

Salaries and wages. For most youth-serving organizations, salaries and wages are the largest part of their annual operating budget. Predicting these costs with reasonable accuracy is important. In addition to current salary costs, consider whether your organization anticipates actions that would affect payroll costs, such as hiring additional personnel or giving any promotions or salary increases. Staff changes are costly and highly disruptive to your employees and your organization. Most importantly, delay hiring for new positions until funding is secure.

Fringe benefits. Methods to project fringe benefit expenses vary. Consider using government publications to estimate the employer's share of Social Security taxes, Medicare contributions, and unemployment insurance taxes for the coming year. Insurance carriers can also provide projected increases in the cost of health, life, disability, and workers' compensation insurance. Once those costs have been determined, create a percentage representing all fringe benefit expenses that can be used for all staff.

Other operating costs. This category includes all other costs of running a youth-serving organization (rent, electricity, supplies, etc.). Identify increases built into leases and other contracts and estimate charges for services, supplies, materials, and equipment needed in the upcoming year. In addition, identify potential increases or decreases in operating costs because of planned changes in services and programming. For example, if your organization changes its hours of operation, its electricity usage will likely change. When expanding staff size, estimate increases in supplies, telephone, and other employee-driven expenses.

Costs of generating future income. Raising revenue usually requires time and effort (e.g., fundraising and/or proposal writing). If anticipated income that has not yet been received is included in the budget, any additional costs associated with generating this revenue should also be included in the budget.

5.9 Comparison of Projected Revenue and Estimated Expenses

After projecting revenue and estimating expenses, the next logical step is to compare the two amounts. Ideally, the projected revenue exceeds—or at least equals—the estimated expenses. However, if expenses exceed revenue, you will have to review your organization's priorities. Ask these questions.

- **Can expenses be reduced?** If so, how can expenses be reduced? If expenses are reduced, can program and service quality be maintained?
- **Can additional revenue be raised?** If so, how can revenue be raised? Can other sources of funding be tapped? What strategies can raise additional funds (for example, making better use of existing resources, maximizing public resources, building partnerships, creating more flexibility in existing revenue, and/or developing new revenue)?
- **If your organization must cut back on services, which programs and/or services are most important?** What are the top priorities for the year? Are certain initiatives more vital to your organization's success than others? Do restrictions on funding limit the choices?

The answers to these questions will inform your organization's actions. You may decide to cut costs, target funding toward key programming, or focus on raising additional revenue.

Action Steps to Address a Cash Shortfall

To address a cash shortfall, your organization can:
- postpone purchases, hiring, or wage increases;
- establish payment schedules for costly items;
- increase the scope and scale of fundraising;
- use volunteers and paid labor more strategically;
- transfer funds from reserves;
- request cash advances from funders;
- consider short-term borrowing; and
- reduce expenses.

Using Budgets as Tools

Budgeting is an ongoing process and a useful management tool. You must constantly monitor your budget against spending activities to ensure the organization is spending according to plan and taking in revenues according to schedule. Through monitoring you can:

- assess how the initial plan compares with current revenue and spending;
- determine how expenses and income compare with previous years or quarters;
- ensure money is being spent according to your plan; and
- identify factors or conditions affecting the rate and level of incoming revenue and outgoing expenses.

5.10 A Shift from Project Budgets to an Organization Budget

Once your budget team has projected revenue and estimated expenses for each project, they can then roll together these individual project budgets into an organization budget. This task is relatively easy for smaller organizations. However, as an organization grows and operates numerous projects, the exercise becomes more complex. Consider these issues when creating your organization budget.

Standardization in budget categories, line items, and cost centers. Create standard categories and definitions for subcategories, if needed. Standardization early in the budget process will prevent confusion and save time as the process continues.

Level of detail needed. The level of detail provided in the budget should be determined by the needs of decision-makers and managers. Budget data can be summarized in detailed project budgets, project budget summaries, and organization-wide income or expense summaries.

- **Detailed project budgets** contain the most information in terms of line items and subcategories. They are used for project management and planning.
- **Project budget summaries** provide summaries of income and expenses in broader categories. They contain less detail than the project budgets. Summaries are used to compare projects within an organization.
- **Organization-wide income and expense summaries** summarize general income and expenses for the entire organization. They are used for organizational planning and management.

Your project managers need detailed project budgets. Budget summaries and organization-wide information may be more useful for you and/or the board of directors.

5.11 Results-Based Budgeting

Your organization may also choose to prepare a results-based budget. Results-based budgets are spending plans that are created specifically to show the connections between program/organizational expenses and the goals they aim to achieve.

Results-based budgets:

- provide a picture of spending by result, in addition to service, program, and/or activity;
- present a framework within which to consider the long-term costs and benefits of improving outcomes; and
- provide a written connection between spending plans and the outcomes they are intended to improve.

DEFINITIONS

Logic Model:

A **logic model** is a diagram or chart that explains your organization's goals and how you intend to meet those goals. It attempts to answer this question: Does it make sense to think that the desired results can be achieved through the planned strategies and activities?

Sample Results-Based Budget

	Results	Strategies	Activities	Expenses
Definition	Broad outcomes/goals trying to achieve.	Approaches used to achieve those goals.	Specific tasks associated with strategies.	Costs of the activities.
Example	Children and youth succeeding in school.	Educational enrichment opportunities for youth during non-school hours.	School-based afterschool programs.	Salaries, supplies, and equipment for afterschool programs.

Creating a results-based budget can be an important part of a strategy for financing and sustaining your organization's work. A logic model or an evaluation can provide a framework for a results-based budget in order to measure the impact of that work.

Budgeting Checklist

Your organization should take these steps to help ensure a sound budget and effective budgeting process.

- Design budgeting policies and priorities based on mission and strategy.
- Set a budget calendar.
- Project revenue, including public and private grants, contributions, income from fees, and asset-generated income.
- Estimate expenses, including direct and indirect costs.
- Compare revenue and expenses and look at cash flow.
- Adjust budget, if needed.
- Approve budget.
- Implement budget.
- Monitor budget (i.e., compare actual amounts with budgeted amounts).
- Revise budget, if needed.
- Revise budget policies, if needed.

5.12 Preparing and Presenting the Budget

One of the most important roles of a governing board is reviewing and approving the annual budget. In order to have productive and efficient input and ratification, you need to provide your board with a well-organized budget package accompanied by a thoughtful presentation.

Components of the budget package. The budget package should contain all the data necessary for the board to make an informed decision without overwhelming them. At minimum, it should include a budget detail, a budget narrative and past and future budgets.

- The budget detail consists of a one-age summary of the organizational budget as well as detailed budgets that provide line-by-line breakdowns of revenues and expenses.
- The budget narrative is a written description of the budget. In text form, it describes the programming goals of the budget and reasons for significant changes in revenue or expenses. It should also include line-by-line notes that state the assumptions behind the numbers. For example, the salary line for a child care program might require an explanation of how many teachers are on the payroll. It's also important to state assumptions. If your budget shows a sharp utility increase, you could say that your oil vendor warned you of a 20% price jump.
- Including past and future budgets will help your board understand the current budget. They need a basis for comparison and a sense of how this year's budget fits into strategic plans going into the future.

Presenting to your board. Appropriately framing the conversation about the budget is essential. Unfocused budget discussions can lead to time-consuming talks about trivial matters. Similarly, if your board does not grasp the key issues facing the budget, it may make a poor decision. When preparing your presentation the following ideas are helpful:

- Use your board ahead of time. Ideally you've been engaging key members of your board throughout the budget process. The board treasurer should be a part of the budget team. If your board has a finance committee they should be involved as well. By doing this, they take ownership of the budget and can speak for it during board meetings.
- Make sure your budget is accurate. It should have no math errors. Before presenting it to the board, ask someone who has never seen the budget to review it with a printing calculator.
- Make the budget visually accessible and appealing. Don't use a tiny font and make sure there is sufficient white space on each page so that the budget is legible. You may want to consider highlighting key numbers or lines in order to guide the conversation.
- Practice the presentation beforehand. If you are confident and in control, it will be easier to keep the discussion on track and productive.

5.13 Reflections on Budgeting Practices

Once a budget process is established, questions such as these can help your budget team evaluate how well the budgeting practices are meeting your organization's needs.

- **How is budgeting linked to planning?** The budget process is a vehicle to discuss goals and priorities for the upcoming year. Be sure the final budget reflects these goals and priorities. The budgeting process can also be a good time to think three to five years into the future with an eye toward longer-term strategic goals.
- **How have staff and the board of directors been involved?** Clearly articulate what input board members and staff should provide on the budget and who is responsible for which decisions.
- **Are budget controls and responsibilities in place?** Board members should clearly understand their roles. Managers should know what line items they are responsible for monitoring, and they should receive the financial reports necessary to monitor these line items effectively.
- **How accurate are cash flow projections?** Any cash shortfalls during the year should be identified, along with steps to cover these shortfalls. If surpluses have been projected, plans to maximize the excess cash should be outlined.
- **How is the budget monitored?** A budget is not only a planning tool, but also provides an important tracking mechanism to ensure program operations are proceeding as planned. A budget variance report is one way to see how current financial activity matches the expected budget (see the Sample Budget Variance Report on page 91). Be sure processes to monitor and update budget projections exist at the project and organization levels. Diligent budget monitoring can also detect fraud. Significant budget variance may reveal deceptive practices.

Additional Resources

For more information on developing a budget for a nonprofit, see M. Dropkin and B. LaTouche, *The Budget-Building Book for Non-profits*: A Step-by-Step Guide for Managers and Boards (San Francisco, Calif.: Jossey-Bass Publishing, 1998).

For more information on nonprofit financial management, see C. McNamara, *Basic Guide to Non-Profit Financial Management* (Minneapolis, Minn.: Authenticity Consulting, LLC, 1999), at: www.managementhelp.org/finance/np_fnce/np_fnce.htm.

For more information on financing strategies for youth programs, see Sharon G. Deich and Cheryl D. Hayes, *Thinking Broadly: Financing Strategies for Youth Programs* (Washington, D.C.: The Finance Project, January 2007), at: http://financeproject.org/publications/Thinkingbroadly_PM.pdf.

For more information on logic models, see Priscilla Little, Sharon Dupree and Sharon Deich, *Documenting Progress and Demonstrating Results: Evaluating Local Out-of-School Time Programs*, (Washington, D.C.: The Finance Project, September 2002), at http://www.financeproject.org/Publications/OSTlocalevaluation.pdf

Sample Cash Flow Budget

REVENUES	January	February	March	April	May	June
Government Grants (State Grant A)			20,000			
Government Grant (State Grant B)	10,000					
Government Grant (County)						10,000
Foundation Grant: Smith Foundation	5,000					
Foundation Grant: Doe Foundation						7,500
Corporate Gifts				1,000		
Individual Contributions	200	1,000	200	200	200	200
Direct Mail		2,000	3,500			
Fundraiser					2,000	
Space Rentals	417	417	417	417	417	417
Fees for Services	650	650	650	650	650	650
Asset-Generated Income						
Office/Classroom Space	1,200	1,200	1,200	1,200	1,200	1,200
Utilities & Insurance	416	416	416	416	416	416
In-Kind Services: Accountant		500	1,500	1,500		500
TOTAL REVENUES	**17,883**	**6,183**	**27,883**	**5,383**	**4,883**	**20,883**
EXPENSES						
Payroll expenses (Salary & Fringe benefits)	4,641	4,641	4,641	4,641	4,641	4,641
Computer Consultant		3,000		3,000	300	
Accountant		500	1,500	1,500		500
Professional Development					1,000	
Transportation	1,250	1,250	1,250	1,250	1,250	1,250
Curriculum Cost	4,000					
Program Supplies	1,050	1,050	1,050	1,050	1,050	1,050
Office/Classroom Space	1,200	1,200	1,200	1,200	1,200	1,200
Utilities & Insurance	417	417	417	417	417	417
Fundraising Expenses					2,000	
Office Supplies	67	67	67	67	67	67
Postage	100	800	100	100	100	500
Dues & Fees	300					
Telephone	125	125	125	125	125	125
Copier Lease	100	100	100	100	100	100
Bank Charges						
TOTAL EXPENSES	**13,249**	**13,149**	**10,449**	**13,449**	**12,249**	**9,849**
Starting Balance		**4,634**	**(2,333)**	**15,101**	**7,035**	**(331)**
Cash In: Revenue	**17,883**	**6,183**	**27,883**	**5,383**	**4,883**	**20,883**
Cash Out: Expenses	**13,249**	**13,149**	**10,449**	**13,449**	**12,249**	**9.849**
Cash Remaining: Surplus/Deficit	**4,634**	**(2,333)**	**15,101**	**7,035**	**(331)**	**10,702**

Sample Operating Budget by Project

REVENUES	South Street Afterschool	Centre Street Teen Center	Total
Contributed Revenues			
Government Grants	20,000	14,000	34,000
Foundation Grants	30,000	45,000	75,000
Corporate Gifts	15,000	10,000	25.000
Individual Contributions	5,000	2,500	7,500
Direct Mail	1,500	2,500	4,000
Fundraiser	8,000	10,000	18,000
Total Contributed Revenues	**79,500**	**84,000**	**163,500**
Earned Revenues			
Space Rentals		1,500	1,500
Fees for Services	700	1,750	2,450
Asset-Generated Income			
Total Earned	**700**	**3,250**	**3,950**
TOTAL REVENUES	**80,200**	**87,250**	**167,450**
EXPENSES			
Personnel			
Salary: Executive Director 50% time @ $48,000/AN	24,000	24,000	48,000
Salary: Program Director 50% time @ $36,000/AN	18,000	18,000	36,000
Salary: Program Assistant, 25% time @ $30,000/AN	7,500	7,500	15,000
Fringe Benefits @ 12.5%	6,188	6,188	12,375
Computer Consultant	1,000	2,000	3,000
Payroll Service	1,500	1,250	2,750
Accountant	7,000	7,000	14,000
Professional Development	2,000	3,000	5,000
Total Personnel	**67,188**	**68,938**	**136,125**
Other Expenses			
Transportation	1,000	2,500	3,500
Curriculum Cost	1,500	750	2,250
Program Supplies	1,000	1,250	2,250
Office/Classroom Space	250	5,000	5,250
Utilities & Insurance	3,500	2,800	6,300
Fundraising Expenses	1,000	1,000	2,000
Office Supplies	500	500	1,000
Postage	250	600	850
Dues & Fees	100	150	250
Telephone	1,250	1,500	2,750
Copier Lease	2,000	2,000	4,000
Bank Charges	75	75	150
Total Other	**12,425**	**18,125**	**30,550**
TOTAL EXPENSES	**79,613**	**87,063**	**166,675**
Net	**588**	**188**	**775**

Sample Budgeting Calendar

(For a January to December Fiscal Year)

January
- Begin using budget for new year
- Track income and expenses and compare to current-year budget

February
- Track income and expenses and compare to current-year budget

March
- Track income and expenses and compare to current-year budget

April
- Track income and expenses and compare to current-year budget

May
- Track income and expenses and compare to current-year budget
- Identify internal and external stakeholders in budget process
- Set policies and procedures for creation of budget, including finalizing budget preparation calendar

June
- Track income and expenses and compare to current-year budget
- Board and senior management establish consensus on goals and tactics for next year, with appropriate input from external stakeholders

July
- Track income and expenses and compare to current-year budget
- Project revenue and expenses for next year based on current-year spending, forecasts from vendors and program plans

August
- Track income and expenses and compare to current-year budget
- Create first draft of budget and submit to Board Finance Committee for their feedback. Make revisions as necessary

September
- Track income and expenses and compare to current-year budget
- Board Finance Committee approves budget, forwards to General Board for their review

October
- Track income and expenses and compare to budget
- General board reviews draft budget and offers feedback

November
- Track income and expenses and compare to current-year budget
- Budget team revises budget based on board feedback

December
- Track income and expenses and compare to current-year budget
- Board votes to approve final budget
- Copies of new budget disseminated to key staff
- Key components of budget and strategy for new year shared with stakeholders

Chapter 6

Applying Financial Management Controls

Financial management controls are the rules, policies, and procedures that describe how financial transactions should be processed in your organization. By consistently applying these controls, you can minimize the opportunities for fraud, waste and abuse. Controls also help ensure that your funding is used for the purposes for which it is given. Finally, controls enable your organization to demonstrate to funders or potential funders that its assets are safeguarded and that your organization is worthy of funding.

6.1 The Importance of Internal Financial Management Controls

Internal controls are the foundation for sound financial management practices. Well-designed controls can provide "reasonable assurance" that your organization's resources are safeguarded and ensure that its plans and strategies are properly implemented. Solid controls can benefit your organization in these ways.

- **Provide reliable data.** Financial management controls ensure the decision-making information your managers and board members need is timely and accurate.
- **Safeguard important records.** Financial management controls protect your organization's money and physical assets, including important records and documents, from theft, misuse, and accidental destruction.
- **Promote efficiency.** Financial management controls reduce unnecessary duplication of effort and guard against misallocation of resources.
- **Ensure compliance with laws, regulations, and organizational policies.** Financial management controls ensure:
    - your financial assets are handled and expended in accordance with federal and state laws,
    - your organization adheres to restrictions and requirements on the use of public and private funds, and;
    - your organization follows internal policies.

- **Avoid embarrassing and expensive interventions.** Allegations of fraud or waste create negative publicity and distract your organization from its real work. Your nonprofit relies heavily on the goodwill of the public to stay in operation. A scandal can sully its reputation for years before the damage is undone. Recognize that financial management controls cannot completely eliminate your organization's exposure to fraud, though strong controls will contain the risk.

Guiding Principles for Internal Financial Management Controls

Financial management controls should address these factors.

- **Organizational fit.** Controls should be tailored to meet the specific needs of your organization and its operations. Controls cannot be implemented on a one-size-fits-all basis.
- **Segregation of duties.** Dividing duties among staff creates checks and balances for all financial transactions.
- **Written rules, policies, and procedures.** Clearly articulated internal rules, policies, and procedures in a written document promote consistent use and application.
- **Outside audits.** Periodic audits by a professional outside your organization help ensure the financial health of the organization by validating reports and recordkeeping practices. Some grants and contracts will require periodic outside audits. State and federal guidelines require groups above a certain size to conduct outside audits.
- **Board expertise in financial management.** Appoint at least one board member with professional knowledge of finance and accounting to help establish controls and review financial statements.
- **Fidelity bonding.** Purchase insurance to bond all financial personnel and protect your organization against embezzlement.

6.2 A Complete System of Internal Financial Management Controls

Your organization should develop internal controls for all activities that involve its money—how it receives money, spends money, pays employees, and invests money. These policies should be developed by the lead finance manager, with input from the board. The following five areas of financial control are described further in Sections 6.3 through 6.7.

Procedures for receipts. These procedures outline what to do when your organization receives money or nonmonetary goods to ensure these resources are recorded and deposited properly.

Procedures for disbursements. These procedures outline how your organization disburses funds (makes payments) to ensure only authorized people have access to account information and are in a position to withdraw funds.

Procedures for petty cash. These procedures outline how funds for small, incidental expenses are accessed and what safeguards exist to protect against theft or misappropriation.

Procedures for payroll. These procedures detail how payroll is calculated and disbursed. They help ensure that relevant federal, state, and local laws are followed.

Investment policies and procedures. These procedures outline how your organization can invest its resources and what safeguards exist to monitor investment decisions.

Financial Management and Staffing [2]

Who should do what? Each organization has different resources and will assign bookkeeping responsibilities differently. Below are several models of staffing that can serve as suggestions, rather than as prescriptions, for actual situations. Small youth-serving organizations often choose to have staff handle initial transactions, while an outside contract accountant handles the bookkeeping and accounting. Larger organizations more typically keep financial functions in-house, though some very large organizations work with contract accounting services.

Organizational Characteristics

- Volunteer Group—all volunteer, small organization.
- Small Organization—approximately five full-time staff, including one administrative assistant, with monthly accounting work done by an outside contract accountant.
- Midsize Organization—approximately 15 full-time staff, including a full-time, full-charge bookkeeper.
- Larger Organization—approximately 30 full-time staff, including a full-time finance manager, a full-time bookkeeper, and a full-time accounting clerk.

Staffing Patterns: Who Does What?

Tasks	Volunteer Group	Small Organization	Midsize Organization	Larger Organization
Open mail, stamp checks	Books kept by volunteer treasurer	Receptionist	Receptionist	Receptionist
Make out deposit voucher	President or person who receives mail	Administrative assistant	Bookkeeper	Accounting clerk
Take deposit to bank	Treasurer or volunteer in charge of fundraising	Administrative assistant	Bookkeeper	Bookkeeper
Record deposit in books	Treasurer or volunteer who keeps books	Administrative assistant records in checkbook; contract accountant prepares disbursement journal	Bookkeeper	Bookkeeper; finance manager reviews
Receive bills in mail	President; most bills submitted by volunteers at meeting for reimbursement	Administrative assistant	Bookkeeper	Accounting clerk
Authorize bills for payment	Treasurer	Administrative assistant (if a general invoice); people in charge of specific areas may authorize payment in their areas	Department heads may authorize payment in their areas	Department heads authorize payment before check preparation
Make out checks	President or treasurer	Bookkeeper or administrative assistant	Bookkeeper	Accounting clerk
Sign checks	Vice president or secretary; two signers for large amounts	Executive director; two signers for large amounts	Executive director; two signers for large amounts	Executive director; two signers for large amounts
Allow other signatories	Not applicable	Other management staff and board officers	Other management staff and board officers	Other management staff and board officers

[2] This edited excerpt is used with permission from CompassPoint Nonprofit Services, 731 Market Street, Suite 200, San Francisco, California 94103. Contact the organization at 415-541-9000 or info@compasspoint.org.

Staffing Patterns: Who Does What?

Tasks	Volunteer Group	Small Organization	Midsize Organization	Larger Organization
Execute payroll	No payroll	Administrative assistant calls in payroll to payroll services company	Bookkeeper calls in payroll to payroll services company	Bookkeeper calls in payroll to payroll services company
Post checks in book	Treasurer	Administrative assistant fills out check stubs; contract accountant prepares journal	Bookkeeper	Bookkeeper
Handle bank reconciliations	Treasurer	Contract accountant	Department manager	Accounting clerk; finance manager reviews.
Make general journal entries (e.g., depreciation and adjustments), maintain general ledger	May not use formal general ledger	Contract accountant	Bookkeeper	Finance manager
Reconcile journals	Treasurer	Contract accountant	Bookkeeper	Bookkeeper
Determine trial balance	Treasurer	Contract accountant	Bookkeeper	Bookkeeper
Create monthly financial statements	Treasurer	Contract accountant	Bookkeeper	Finance manager
File quarterly payroll tax returns	None	Payroll services company	Payroll services company	Finance manager
Monitor budget, propose changes	Treasurer	Executive director and treasurer	Bookkeeper with executive director and treasurer	Finance manager and treasurer
Deliver finance reports to board of directors	Treasurer	Executive director and treasurer	Executive director and treasurer	Finance manager
Project and manage cash flow	Treasurer	Administrative assistant	Bookkeeper with executive director	Finance manager
Develop investment policy	Executive director and treasurer	Executive director and treasurer	Executive director and treasurer	Finance manager, executive director, and investment committee
Meet with auditor	Not audited	Executive director interviews; board hires	Executive director interviews; board hires	Executive director interviews; board hires
Prepare initial draft of budget	Board officers together	Executive director	Executive director; bookkeeper helps	Finance manager
Approve budget	Board of directors	Board of directors	Board of directors	Board of directors
File annual forms, including Form 990	Too small to file	Contract accountant or auditor	Tax specialist	Tax specialist

TIPS

Board Members and Volunteers Can Help

Consider asking board members and trusted volunteers to help with financial management tasks, especially if your organization has a very small staff.

6.3 Receipts Procedures

Establishing controls over receipts ensures that a record of these funds or assets is maintained and that funds are promptly deposited in your organization's bank account. Procedures should be established for both cash and noncash items (see the Cash and Noncash Receipts Checklist on page 59).

Following are procedures for creating and tracking receipts.

- Create a mail control process. All mail should be treated as if it contains checks to your organization. Designate who receives the mail and who opens it and enforce that system.
- Ensure cash collections are under the control of two people, whenever possible. Working together, one person can open the mail and record checks, while the other can prepare the bank deposit. This can safeguard your organization against employee misconduct and help ensure receipts for cash collection are accounted for properly.
- Issue prenumbered receipts for all money (cash and checks) at the time it is first received. A duplicate copy should be kept for accounting records and, eventually, the total of the receipts issued should be compared with the amount deposited in the bank.
- Endorse receipts in the form of checks as "for deposit only" promptly upon receipt.
- Deposit all money (cash and checks) in the bank on a timely basis. How often your organization deposits money will depend on the amount, type, and frequency of funds it receives. The board can help establish an efficient policy for handling deposits.
- Document the value of noncash goods and services. Typically, the donor can provide an estimate of the value. Depending on the value of the donation, provide a letter or receipt acknowledging the donation. (See Sample Noncash/In-Kind Donation Receipt Form on page 71.)

All mail should be treated as if it contains checks to your organization.

Cash and Noncash Receipts Checklist

- Are two people responsible for opening the mail and recording the receipt of checks?
- Are prenumbered receipts issued for all cash received? Are receipts prepared in duplicate, with one copy going to the source of contribution and one copy filed with your organization's records?
- Are two people responsible for counting and logging all cash collections?
- Is a log or ledger of all receipts of contributions maintained?
- Are cash and checks deposited in the bank on a timely basis and in the amount and form in which they were received?
- Does your organization use a secure, locked box to store cash contributions? Are bank deposits made from this box on a daily basis? Does the bank send a list of all deposits made to the account?
- Does your organization have a process for tracking electronic transfers?

6.4 Disbursements Procedures

Internal controls over disbursements (payments) help ensure payments and expenditures are recorded and only authorized people have access to account information and can withdraw funds (see the Disbursements Checklist on page 61). Internal disbursement controls significantly reduce the risk of misappropriation.

Following are procedures for tracking disbursements.

- Establish a clear process for approving payments. Authorization should be required for all disbursements by someone other than the check signer.
- Limit and identify who is authorized to sign checks. If the treasurer or check signer is also the bookkeeper, two signatures should be required on each check. Two signatures should also be required for checks above an established amount (for example, $1,000).
- Use prenumbered checks for all disbursements and keep supporting documentation for each payment.
- Keep checks in a locked cabinet. The check preparer should not have access to blank checks.
- Do not write any checks for cash.

DEFINITIONS

Disbursements:

Disbursements are payments the organization makes to cover its expenses.

- Preserve and file voided checks.
- Keep good records of all payments your organization makes. Cash disbursement vouchers should be prepared for each invoice or request for payment. A cash disbursement voucher is a request for a check (payment, reimbursement, or cash advance) and should include details such as the date of the check, the check number, the payee, the amount of the check, a description of the expense account and/or restricted fund(s) to be charged, an authorization signature, and accompanying receipts. (See the Sample Check Request Form on page 72.)
- Ensure a person other than the bookkeeper opens the envelope and reviews the bank statements.
- Use purchase orders to ensure proper authorization of purchases.
- Require employees and others who travel on behalf of your organization to submit expense reports and receipts for travel-related expenses on a timely basis (for example, within a month or six weeks).
- Issue credit cards for business-related purposes only to authorized individuals. Monthly statements should be reconciled with receipts by someone other than the cardholder. Establish reasonable limits on individuals' use of their issued credit card.
- Review actual expenditures versus the budget monthly.

Disbursements Checklist

- Are all disbursements, except those from petty cash, made using prenumbered checks?
- Is the unused check supply safeguarded?
- Are all voided checks mutilated and filed?
- Is there a written prohibition against drawing checks payable to cash?
- Is a cash disbursement voucher prepared for each invoice or request for reimbursement?
- Must all expenditures be approved in advance by authorized, nonaccounting personnel?
- Are signed checks mailed promptly?
- Does the check signer review the cash disbursement voucher for authorization and supporting documentation of expenses?
- Are invoices marked PAID with the date and amount of the check to prevent repayment?
- Is a cash disbursement journal prepared on a monthly basis that gives the date of the check, the check number, the payee, the amount of the check, and a description of the expense account to be charged?
- Is check-signing authority vested in persons at appropriately high levels in the organization?
- Do checks require two signatures? Do checks above a specified amount require two signatures?
- Are bank statements and canceled checks received and reconciled by a person independent of the authorization and check-signing functions?
- Are unpaid invoices maintained in an unpaid invoice file?
- Are purchase orders used with all transactions?
- Are advance payments to vendors and/or employees recorded as receivables and offset against invoices or expense vouchers?
- Does your organization have a system for conducting and tracking electronic transfers and other online banking transactions?

6.5 Petty Cash Procedures

Why have petty cash? An organization may need to make miscellaneous small purchases and, in these instances, it makes more sense to use cash than to be reimbursed through the regular disbursement process (see the Petty Cash Checklist below). The sum of money set aside does not need to be large; a small organization may have a petty cash fund of $100.

Following are procedures for tracking petty cash expenditures.

- Establish a clear policy on the amounts and purposes for which petty cash can be used and the initial size of the petty cash fund.
- Designate one person—a custodian—as in charge of petty cash. This custodian should respond to petty cash requests and keep a journal of all transactions (i.e., payments from petty cash and checks to replenish the petty cash fund). (See the Sample Petty Cash Journal on page 70.) The initial check to establish the petty cash fund and subsequent checks to supplement the fund should be made payable to the custodian.
- Keep the petty cash in a locked box with access limited to the custodian.
- Issue vouchers for petty cash advances and require receipts for reconciliation. (See the Sample Petty Cash Fund Disbursement Form on page 69.)
- Require receipts for reimbursement.
- Require the custodian to regularly reconcile the petty cash records, verifying that the receipts plus cash available equals the amount in the petty cash fund.
- Have the custodian submit the receipts to the bookkeeper to have the petty cash fund replenished as the petty cash is spent.
- Have someone other than the custodian conduct unannounced checks of the petty cash fund and controls. This individual should verify that the appropriate amount of petty cash remains and that the receipts and the journal of transactions are in order.

Petty Cash Checklist

- Is a petty cash fund maintained to pay small, incidental expenses?
- Are petty cash funds disbursed to the custodian of the fund by a check payable to that individual?
- Is there a limit on the amount that can be reimbursed by the petty cash fund?
- Is supporting documentation required for all petty cash disbursements?
- Is access to petty cash limited to the fund custodian?
- Is the petty cash fund custodian required to reconcile the fund on a regular basis (e.g., weekly or monthly)?
- Are unannounced counts of petty cash conducted by someone other than the fund custodian?

6.6 Payroll Procedures

Establishing controls over payroll helps ensure that payments are made only to bona fide employees—upon proper authorization of management—and that the payments comply with federal, state, and local requirements (see the Payroll Checklist on page 64). Executing payroll properly not only ensures your organization is being a responsible employer, but also keeps the staff happy. Following are procedures to conduct the payroll function.

- Designate who is authorized to hire new employees and determine salary.
- Require written authorization for hiring and changing pay rates (for example, salary increases).
- Establish clear policies for the payroll process, overtime, sick leave, vacation and holiday leave, and other leave with or without pay. Employee handbooks can offer clear guidelines and reduce exposure to employee complaints and lawsuits. The policies should be communicated to all employees. They should also be reviewed regularly to ensure compliance with state and federal laws.
- Require written or online timesheets to be completed and signed by employees and submitted to a supervisor or other authorized person. Supervisors or other authorized personnel should review and approve the time records. Time sheet formats should match the organization's structure. For example, organizations with multiple funds should direct employees to track their time by fund.
- Keep proper forms for federal and state taxes for each employee. Authorized personnel should make timely payments of taxes and other withholding to avoid costly penalties as well as keep careful records of when payroll taxes and employee benefits are paid.
- Segregate duties that relate to budgeting, payments, recordkeeping, tax filing, and approval of time sheets; do not have one person in charge of all payroll tasks. Two people should review the payroll run records, especially in cases where the paycheck is automatically signed by a payroll services company.

TIPS

Payroll Service Companies Are a Good Idea

Use a professional payroll services company rather than do payroll in-house. Such companies stay current on all regulations from federal, state, and local authorities and simplify end-of-year reporting requirements to employees. Moreover, they do so more efficiently and cost-effectively than internal staff.

- Issue paychecks from a separate payroll bank account. Authorized personnel should remove and void unclaimed paychecks and then preserve and file those checks. Your payroll services company may debit the primary disbursement account for the full amount of the payroll, even unclaimed checks; this debiting should be monitored.

You should get advice on two key payroll-related issues. First, when is it appropriate to treat an employee as an independent contractor and issue a Form 1099 and when is it necessary to place that person on the payroll, with all the associated deductions and benefits? Second, within your organization, what is the difference between exempt (salaried) employees and nonexempt (hourly) employees? The answers to both these questions depend on the nuances of the positions under consideration as well as federal and state employment laws. Obtaining the opinion of a legal expert in these matters is a wise course. Information is also available at www.irs.gov.

Payroll Checklist

- Are detailed time sheets required to document employee hours, including overtime, vacation time, holiday leave, and other forms of leave?
- Are time sheets signed by the employee's immediate supervisor authorizing payment for work?
- Are employment records maintained for each employee that contain his or her letter of hire, salary information, benefits, federal and state withholding forms, taxes withheld for each pay period, annual performance reviews, and any changes in employment status?
- Are payroll-related taxes withheld (e.g., federal income tax, state income tax, and employee and employer shares of Social Security) and required taxes to federal and state agencies paid on a timely basis?
- Do the executive director and board treasurer review all the payroll tax returns?
- Are there written policies and procedures for tracking vacations, holidays, sick leave, and other benefits?
- Is a list of all payroll checks maintained, with appropriate withheld taxes, through the cash disbursement journal or a separate payroll register?
- Is a separate payroll bank account maintained?
- Does a second person review each payroll journal?
- Are all unclaimed paychecks held and filed?

Recognize that fraud and embezzlement can happen in any organization at any time. The variety of schemes that can be perpetrated against your organization is virtually limitless. Financial controls are critical for preventing fraud, but smart leaders should also take these steps.

- Avoid giving a single employee too much responsibility for financial transactions. Fraud happens when motive, opportunity, and rationalization are present.
- Arrange for regular, outside independent audits for your organization. (See Chapter 9 for more information on audits.)
- Conduct monthly reconciliations of your organization's bank statements with its financial records in between audits. These reconciliations should be reviewed by a second person. If your organization is vulnerable, a knowledgeable person should review, at a minimum, payroll reports, vendor lists, and accounts receivable details.

6.7 Investment Policies and Procedures

Your organization should invest its assets to:

- preserve restricted funds for specific projects and activities;
- preserve and grow reserve funds for building capacity to address new and emerging needs; and
- protect itself in case of emergencies or other adverse circumstances.

Your organization may sometimes receive grant payments for multiple years and/or be able to set aside some funding for slower periods. Prudent short-term and long-term investments can add to current income in ways that will benefit your organization in both the short and longer terms. In choosing investments, you must balance the risk of investment with possible return (i.e., profit or money made on investment). A board member with a financial background can help an organization develop informed policies and choices about investments. Alternatively, your organization can seek help from a financial planner.

TIPS

Online Banking Requires Controls Too

If your organization decides to begin banking online, consider what kinds of transactions and controls your organization needs. Will online banking be limited to payroll or will it include paying bills? What kind of paper trail will you create for online operations?

PITFALLS

Investments Should Not Conflict with Mission

Avoid investments that do not reflect the values of your organization. For example, some programs that serve teens will not hold stock in firearms companies. Your organization may choose to limit itself to socially responsible investments.

Investment Management Committee. Given the potential complexity of investment decisions, creating an investment management committee can be valuable. An investment management committee is a subcommittee of an organization's board of directors that provides review and advice for investment strategies. The committee should operate under clear and established guidelines that define, in detail, the limits on asset allocations and investment classes, requirements for reporting to you and the board of directors, conflict-of-interest policies, and other matters pertaining to the investment of your organization's assets. The investment management committee should meet no less than twice annually to review an organization's asset allocation and should meet more often if economic and market conditions warrant.

Investment Policies. A clear set of investment policies and procedures is essential. When considering your investment options, several actions will help ensure success.

- Identify how much excess money is available to invest and for how long. Use conservative projections for cash flow when determining the amount of funds for investment and the periods of investments.
- Create a timeline for the investment portfolio. Some investments mature over a set period (30 days, 90 days, etc.) and are then available for use or reinvestment. Time the investments so cash is available when it is needed or on a periodic basis. Longer maturities usually carry higher rates of return at the same level of risk. For example, checking accounts pay next to nothing, while a six-month Treasury bill can carry significant interest.
- Always assess the risk of a proposed investment. You must invest prudently and protect the security of the principal (e.g., the initial investment). Your board members and senior management have a responsibility to protect the initial investment. Determine how much short- and long-term risk is acceptable.
- Pursue investments that maximize gain and minimize risk. The purpose of investing is to make money (i.e., earn a return) on the money invested. Investments that bring higher returns often also carry higher risk. The challenge is to balance the potential for profits from an investment with the risk of the investment. This requires frequent reassessment as economic conditions and market opportunities change.

- Consider including a stable investment income, such as investments that provide regular scheduled payments upon maturity and are highly secure (e.g., Treasury bills).

- Take into account how easy it is to redeem the investment for cash (i.e., the liquidity of the investment). Your organization may face an unexpected budget crisis and need to use the invested funds sooner than anticipated. The ability to quickly sell or dispose of an investment without being penalized is an important consideration, for at least a part of the portfolio.

- Diversify the investments to help balance risk, liquidity, and rate of maturity. This strategy can help reduce risks and ensure funds are available when needed. Diversification involves using separate investments of varying maturities (e.g., three months, six months, or one year). It may also involve multiple investment types, such as Treasury bills and money market accounts.

- Remember that savings accounts are only insured by the Federal Deposit Insurance Corporation (FDIC) for up to a set amount, which has recently changed. Any funds above that amount should be placed in a more secure financial instrument, such as Treasury bills.

- Understand and follow any other restrictions on investments. If your organization is investing funds granted from a donor, clear the investments with the donor first.

- Consider retaining a professional financial manager. A good one can offer expertise that far outweighs any fees he or she may charge.

Investment Options. Common and low-risk investment options include money market accounts, certificates of deposit, and Treasury bills.

Money market accounts. Banks, brokerages, and insurance companies offer money market funds, also known as mutual funds, which are similar to checking accounts but have greater limitations on transactions. These accounts typically require a minimum balance, with higher balances receiving higher interest rates. They are considered low risk, but they also tend to have lower interest rates than other investment options. If your organization is worried about liquidity, these accounts can be easy to access. You can usually withdraw funds without a penalty, so long as you stay above the minimum balance.

DEFINITIONS

Maturity:

Maturity is the duration the investment earns interest or needs to be repaid.

Certificates of deposit. These are promissory notes issued by banks or other financial institutions. Money is deposited with the institution for a prescribed period and receives a set interest rate. The duration of the deposit (maturity) varies from one month to many years, with longer maturities receiving higher interest rates. A penalty exists for withdrawing the money prematurely.

Treasury bills. Treasury bills, or T-bills, are sold by the U.S. government and mature in a year or shorter period—typically one month, three months, or six months. Instead of gaining value for the investor through an interest rate, T-bills are sold at a discounted rate and are redeemable at face value.

6.8 Reflection on Controls

Your organization's financial controls are the backbone of your financial management system. As you create and execute controls keep these ideas in mind.

- Set up controls that support the organization, not ham-string it. Make the controls appropriate to the situation: transactions involving small amounts of money (such as petty cash disbursements) can have fewer controls than transactions that involve large amounts of money.
- Use two staff at critical decision points. This can include having two people sign checks over a certain amount or having two people collect money.
- Employ checks and balances. The person who prepares the payroll run should be different from the person who reviews the payroll reports.
- Change your controls as needed. As your program evolves, you will see that controls must evolve too. Revisit your controls annually to see what works and what needs updating.

Additional Resources

For more information on financial management in nonprofits, visit the website of the Alliance for Nonprofit Management at www.allianceonline.org/nonprofits.ipage.

For more information on financial accountability in nonprofits, see www.idealist.org/npofaq/18/58.html.

For more information on federal rules for nonprofit fiscal management, see www.practitionerresources.org/cache/documents/36057.pdf.

For financial management templates and samples, see www.mncn.org/info/template_fin.htm.

Sample Petty Cash Fund Disbursement Form

Payee: ______________________________

Amount: ______________ Date: ______________

Purpose: ______________________________

____

Receipt Attached? Yes No

Cash Disbursed by: ______________________________

____

____

Charge to Account Number: ______________________________

____

Approved Signature Date

Sample Petty Cash Journal

Month of ________________ , __________

Date	Amount	Explanation/ Account	Payee	Receipt Attached	Approved	Balance

Monthly Reconciliation

Beginning Balance: ____________________

Deposit Total ____________________

Disbursement Total: ____________________

Ending Balance: ____________________

Current Cash on Hand: ____________________

Difference: ____________________

Explain (if other than 0): ____________________

____

Prepared By Custodian Date

____

Reviewed By Executive Director Date

Sample Noncash/In-Kind Donation Receipt Form

Name: ______________________________

Address: ______________________________

Phone: ______________________________

Value of Service: ______________________________

Consultant's Profession or Trade: ______________________________

Rate per hour $ _______ /per hour

Total number of hours: _____________

Total Value of Service:

Date	Miles	Service Rendered	TIme Donated

Value of Goods:

Items	Value
Total Value of Donated Items	

Signature ______________________________ Date

Organization Administrator Signature ______________________________ Date

Thank you for your contribution. A copy of this form will be mailed to you for your records.

Sample Check Request Form

Payee		Account Number	
Address		Invoice Number	
Address		Invoice Date	
City, State, Zip		Due Date	
Tax Identification Number		Form 1099 Required	☐ Yes ☐ No

Line Item Description	Account Number	Amount
	Invoice Total	

Requested by Date

Reviewed by Date

Mode of Delivery

- ❑ Payee Pickup
- ❑ Courier to Payee
- ❑ Mail to Payee
- ❑ FedEx to Payee
- ❑ Client Pick Up

Chapter 7

Allocating Overhead

Because your nonprofit organization enjoys a tax-exempt status and often relies on donations to exist, you must demonstrate to your benefactors and the general public that you are operating efficiently and without waste. Overhead costs are sometimes used as a shorthand indicator for this. Even without the pressure of outside scrutiny, overhead costs are an important part of your budget. For these reasons, your lead financial manager must be able to identify overhead rates to help with fundraising and monitoring operations.

7.1 Overhead Defined

Overhead, or indirect expenses, are costs that are not directly attributable to specific programs or activities but are necessary to your organization's program operations. Examples of overhead include rent, telephone, and accounting expenses. (In contrast, direct costs include program staff salaries and program materials.) For many indirect items, you can account for each one separately in the budget or lump them together in an overhead category.

Overhead Costs

Overhead costs, or indirect expenses, usually include:

- salaries for management and administrative staff;
- fringe benefits;
- rent;
- telephone and other utilities;
- postage;
- printing;
- vehicles;
- supplies; and
- other shared resources.

7.2 Reasons to Allocate Overhead

Overhead costs usually are treated differently from the direct costs of your organization because they cut across many, if not all, functions and activities. Overhead would exist absent a specific program or activity. For example, a youth program would have to pay rent regardless of whether its mentoring component was operating. Likewise, the program would require basic telephone services regardless of the mix of activities. Some administrative capacity would also be necessary to keep your program running. If your youth-serving organization sets limits on how much of its total resources can be used for indirect services, you must be able to monitor and justify overhead expenses.

Tips for Reducing Overhead Costs

Nonprofits often strive to do the maximum administration with the minimum amount. You can take these steps to reduce overhead costs:

- make sure your organization does not have any excess administrative capacity (for example, unused space or administrative staff hours);
- buy your supplies in bulk, which saves time and takes advantage of quantity discount pricing;
- negotiate with all your vendors (for example, phone companies, Internet providers, and supply vendors), leveraging the competition among them to obtain additional savings on goods and services; and
- analyze your work patterns to ensure efforts are not being duplicated and the programs are operating efficiently.

7.3 Methods to Allocate Overhead

No single method for calculating your overhead or allocating indirect costs across programs exists. The nonprofit community uses several methods, and the method your organization chooses will depend on its needs. If your organization is small and has comprehensive records of staff time and space used for each project, you can easily allocate or spread indirect costs across the projects in a proportional manner. As your organization grows in size and complexity, accurate estimates are more difficult. Three of the most common methods for allocating indirect costs are an activity-based method, a method based on an indirect cost rate, and an activity-based costing method.

Activity-based method. This method assigns indirect costs to specific programs or activities by determining the actual overhead costs for each of your programs or activities. For example, your organization may allocate rent according to the amount of space a program or an activity uses. You can allocate other overhead costs by tracking postage expenses in a log book, keeping a log book of photocopies, and/or maintaining a log of vehicle mileage. This can work for some of your indirect costs, but other overhead expenses may be difficult to allocate this way. For example, fundraising costs do not necessarily map to a specific program or activity.

Indirect cost rate method. For shared expenses that cannot easily be divided among programs and functions, you can develop an indirect cost rate. To develop a rate, first separate all costs into two groups: direct costs and indirect costs. The indirect costs are combined into an indirect cost "pool" and then allocated among programs based on a set rate or proportion, such as a percentage of budget, labor, or space used.

<u>Percentage of budget.</u> One common way you can allocate the pooled indirect costs is to look at the percentage of each of your program's direct costs relative to the total direct cost budget for your organization. If your program's direct costs are the same proportion of the total budget, then each would split the indirect costs evenly. However, if your program's direct costs are larger than the other programs' direct costs, it would be allocated a larger share of the indirect costs. The following example illustrates how an indirect cost rate can be calculated based on a percentage of budget.

The Chester Youth Development Program (CYDP) has a total budget of $4,500, and the budget is distributed as follows:

- Tutoring program: direct costs of $1,000
- Job training: direct costs of $2,000
- Mentoring: direct costs of $1,000
- Total direct costs: $4,000
- Indirect costs to run the programs: $500

The tutoring program's direct costs are 25 percent of the total direct costs of the agency ($1,000 out of $4,000), so it should bear 25 percent, or $125, of the indirect costs (25 percent of $500 equals $125). The budget for CYDP might look like this:

	Tutoring Program	Job Training	Mentoring	Total
Direct Costs	$1,000	$2,000	$1,000	**$4,000**
Percentage of Total Direct Costs	25%	50%	25%	**100%**
Indirect Costs	$125	$250	$125	**$500**
TOTAL COSTS	**$1,125**	**$2,250**	**$1,125**	**$4,500**

The percentage-of-budget allocation method can work well for your organization. However, in some cases, your program may have a large budget but a small percentage of overhead resources (for example, if your program passes through funds from outside sources but does not conduct activities itself). This will skew the overhead allocation.

Percentage of labor. The indirect cost rate can also be determined by the percentage of labor expended. Labor can be determined by salary costs or the number of hours your staff members spend on different activities. This method can be more accurate if your organization's labor allocations match up well to organizational effort. The following example illustrates an indirect cost rate calculated by the percentage of labor in terms of hours worked.

Chester Youth Development Program employees work 10,000 hours annually. By program, staff members work as follows:

- Tutoring program: 4,000 hours
- Job Training: 4,000 hours
- Mentoring: 2,000 hours

The indirect costs to run the programs total $500. The tutoring program's staff account for 40 percent of the work hours (4,000 out of 10,000), so it should bear 40 percent, or $200, of the indirect costs (40 percent of $500 equals $200). Under the percentage-of-labor allocation method, the indirect costs for CYDP would be allocated as follows:

	Tutoring Program	Job Training	Mentoring	Total
Staff Hours	4,000 hours	4,000 hours	2,000 hours	**10,000 hours**
Percentage of Total Staff Hours	40%	40%	20%	**100%**
Indirect Costs	$200	$200	$100	**$500**

Percentage of space used. Other programs look at how much space each program uses to allocate overhead. This may be helpful when you think about allocating overhead such as utilities, but it can be difficult if there is substantial overlap in facility use among programs. The following example illustrates an indirect cost rate allocated by the percentage of space used.

Chester Youth Development Program uses a facility that is 5,000 square feet. By program, facility use is as follows:

- Tutoring program: 2,500 square feet
- Job Training: 1,000 square feet
- Mentoring: 1,500 square feet

The indirect costs to run the programs are $500.

The tutoring program takes up 50 percent of the facility (2,500 square feet out of 5,000 square feet), so it should bear 50 percent, or $250, of the indirect costs (50 percent of $500 equals $250). Under the percentage-of-space allocation method, the allocation of indirect costs for CYDP would look like this:

	Tutoring Program	Job Training	Mentoring	Total
Square Feet	2,500 sq. ft.	1,000 sq. ft.	1,500 sq. ft.	**5,000 sq. ft.**
Percentage of Total	50%	20%	30%	**100%**
Indirect Costs	$250	$100	$150	**$500**

Activity-based costing method. This method allocates overhead in a two-step process, blending the activity-based method and the indirect cost method. First, it assigns as much of the indirect costs to the relevant program or budget item as it can, including costs such as telephone charges and photocopying fees, that can be associated with a project or activity. The remaining overhead is then allocated using an indirect cost rate (a percentage of budget, labor, or space).

The method of overhead allocation chosen should be the one most appropriate for your organization. Regardless of the method, it should:

- be a rational and justifiable written allocation plan;
- not require excess capacity;
- be reasonable, applied consistently, and substantiated; and
- take into account the requirements of your funders; some funders have specific guidelines and require the use of specific indirect cost allocation methods.

7.4 Ways to Calculate Overhead Rates

Overhead rates are typically calculated by dividing the indirect costs by direct costs. In the example presented in the previous section, the Chester Youth Development Program would have an overhead rate of 12.5 percent; it has $500 of indirect costs and $4,000 of direct costs. However, calculating overhead rates for your organization may not always be so cut and dry.

The nonprofit community lacks a consistent standard for deciding what expenses to include in overhead calculations or what a reasonable overhead rate should be. Overhead rates will vary depending on your organization's size, age, and sources of income.

Calculating overhead is further complicated by the fact that different funding organizations have different rules on what should be included in calculating overhead and what is considered an acceptable or reasonable overhead rate. For example, some funders may require fundraising costs to be included in the overhead figure. Other funders may want fundraising costs listed separately. Your youth-serving organization may need to develop several overhead rates, especially if it receives both public and private funding; this can be a time-consuming task if your organization is small and receives funding from multiple sources. Regardless of how your organization chooses to calculate overhead, it must comply with the contractual definitions of the funding agencies as well as standard accounting principles and Internal Revenue Service rules.

Overhead rates may attract scrutiny from your funders and other stakeholders. The truth is that overhead rates can and should vary according to the status of your organization. If your organization is a smaller nonprofit, it may have higher overhead rates because of less programming over which to spread basic administrative costs. If your organization is new, higher overhead rates are likely because of large startup costs (for example, purchases of supplies).

An overhead rate should not be excessive. Yet the rate cannot be so small that it makes it difficult for your program to operate.

TIPS

Funders May Have Unique Overhead Allocation Requirements

Contact the funder's program officer if a funder is requesting that overhead be allocated in a way that does not fit the structure of your organization. Frequently, a simple conversation will lead to an adjustment of the requirements.

Overhead rates will fluctuate over time. As your organization grows, programs and activities may exceed your organization's administrative capacity and it will need to develop new and/or additional administrative systems. The increments by which you increase your administrative capacity may not always be directly related to incremental increases in programs or activities. All these factors contribute to fluctuations in overhead rates.

Your lead finance managers should adopt a measured approach to the overhead rate. An overhead rate should not be excessive. Yet the rate cannot be so small that it makes it difficult for your program to operate. Your managers should be aware, however, that overhead must be paid for. If your organization does not have sufficient general operating support and a low overhead rate, it can run into financial difficulties even if its programs are successful and well funded.

Additional Resources

For more information on functional expense reporting in nonprofits, see www.nysscpa.org/cpajournal/2006/806/infocus/p14.htm.

For more information on what is known about overhead costs in the nonprofit sector, see www.urban.org/publications/310930.html.

Chapter 8

Creating and Using Financial Reports

Financial reporting is both a process and a product. Done well, it enables you to accurately summarize, analyze, and monitor the fiscal condition of your organization on a timely basis. This helps ensure that your managers have the information to make good decisions and that the organization has the resources to carry out its mission. Financial reporting helps hold your organization accountable to its goals and objectives.

8.1 Thinking About Financial Reports

Financial reports are the end product of the accounting process. They summarize all transactions for a given period and provide detailed information on the actual dollars your organization takes in and spends. They can also offer projections or estimates of what is expected. With this information you can anticipate your organization's fiscal health, problems, or opportunities. Moreover, financial reports are necessary to demonstrate to funders that money is being spent for the purposes for which it was granted.

To be meaningful, financial reports should be:

- easy to understand, so anybody who reads them can quickly grasp the financial picture;
- concise, so the person studying them will not get lost in the detail;
- all-inclusive in scope and embrace all activities of the organization; and
- available on a timely basis; the longer the delay after the end of the period, the longer the period before action can be taken.

TIPS

Financial Reports Are As Useful As You Make Them

Be sure all financial reports are:

- clear;
- accurate;
- timely; and
- tailored to the needs of people working at different levels, both inside and outside your organization.

Use reports for:

- monitoring performance;
- detecting fraud;
- making internal decisions; and
- demonstrating accountability.

8.2 Using Financial Reports

Financial reports are the dashboard display for your nonprofit's operations. To make good decisions about their work, your managers need to regularly review and analyze various financial reports. Basic reports include a statement of financial position, income and expenditure reports, budget variance reports, cash flow reports, project reports, and management reports.

A statement of financial position. This report is also referred to as a balance sheet. It provides a snapshot of your organization's financial position at a moment in time. It lists assets (for example, cash and buildings) and liabilities (debts) and shows the balance. This report becomes more important as the size and resources of your organization increase.

Income and expenditure reports. These reports are sometimes called statements of activity or, more commonly, profit and loss statements. They show the sources of actual revenue received and actual expenditures made. An income and expenditure report can be created for the organization or a specific program, project, and/or service.

Budget variance reports. These reports reveal the amount or percent by which actual revenues and expenses differ from earlier projected figures. Typically, they are prepared on a quarterly or monthly basis. These reports are used to determine how accurate budget estimates were for each category of revenue and expense, highlighting categories where expenditures exceeded projections or were lower than expected.

Cash flow reports. These reports compare projected cash flow with actual expenditures and revenues. They show when revenues were received and when expenditures were made as well as whether your organization had (or will have) a cash surplus or deficit. Cash flow budgets are extremely helpful for planning purposes and can be produced annually, monthly, or quarterly. The emphasis of a cash flow report is on looking forward to avoid a cash crunch.

Management reports. Management reports address questions on revenues and expenses in specific categories for internal decision-making. These reports can take many forms. For example, if you want to closely monitor administrative expenses, you can develop a report that summarizes this data. A report on administrative expenses could include information on rent, salaries, fringe benefits, and other administrative expenses; how much is budgeted for the year and the current month; actual expenditures; and variances.

8.3 Identifying Reporting Needs

Determining who needs what information and how often information is needed are critical in developing systems for financial reports.

You and your lead finance manager:

- need to access all financial reports in a timely manner, reviewing, at least monthly, organization-wide reports that include line-item details on revenues and expenses within and across all projects and functions;
- must carefully review reports prepared for board members and funders; and
- should review year-end reports and summaries of activities.

Program managers and project directors:

- need information to create annual budget projections; and
- should review program- or project-related income and expense reports monthly to effectively manage the resources associated with the programs or projects they manage.

Board members and/or committees:

- have ultimate fiduciary responsibility and need to receive regular reports—typically, quarterly, but more or less often depending on the organization—on the financial status of the entire organization, including details on revenues and expenses within and across all projects and functions; and
- approve budgets for your organization.

External funders and partners:

- should receive audited financial statements annually or upon request, including statements related to financial position, activity, functional expenses, and cash flow; and
- should receive additional reports as required by specific grants or funding agreements.

What Kind and Level of Detail Should a Financial Report Have?

Providing the right type and amount of information for different decision-makers is an important consideration when preparing financial reports. The following questions can help determine the kind and level of detail to include.

- **Organization-wide versus project-specific.** Should the report cover your entire organization or just the projects that a single manager oversees?
- **Broad categories versus line items.** Is it necessary to include detailed line items for each category (for example, the specification of each salaried position) or just the broad category (for example, salaries)?
- **Budgeted versus actual figures and variances between the two.** Do you want to track the variance between budgeted and actual figures? Is it important to include explanations for variances?
- **Period comparisons.** What period comparisons will be most meaningful to you? You may want to see figures for the current month or quarter, for the year to date, and for the same period in the previous year.
- **Audited versus unaudited statements.** Do you have a preference or need for audited statements?

Keep in mind that financial reports must sometimes also reflect the value of in-kind contributions from volunteers. Many nonprofits forget to include the time and effort of volunteers in calculating their assets. Financial Accounting Standards Board Statement Number 116 outlines how nonprofits are required to account for in-kind contributions. Your nonprofit must account for volunteer time in its financial records if the volunteer's service resulted in creating or enhancing a nonfinancial asset (for example, renovation of a community center owned by the organization) or required a specialized skill that would otherwise have to be purchased (for example, donation of book-keeping services by an accountant).

To calculate the true cost of a program, volunteer efforts must be considered. Keep good records of how many volunteers the organization has, how many hours they work, and what they do. Although it may be easy to use the minimum wage to determine the dollar value for volunteer time, the work the volunteers do likely has a much higher value than the minimum wage. If possible, identify salaried positions in the area job market that equate to the tasks assigned to different types of volunteers (direct service, administrative, etc.) and use those jobs' wage rates. Only use the volunteer's wage rate if the volunteered services correspond to his or her employment (for example, do not use a doctor's salary if his or her volunteer work is stuffing envelopes).

Be careful not to mix the value of in-kind wages with other, cash wages. Also, because you must account for the value of both an income and expense item when recording in-kind wages, be careful that the two halves of the equation match up.

Pricing Out the Value of a Volunteer

YouthServices, Inc., in Anytown, Anystate, needed to renovate a conference room in its new facility. Jim Burke, a local carpenter, agreed to donate the work and completed the job in a weekend. What was the value of his service?

The current market hourly rate for a carpenter in Anytown: $50 per hour
Number of hours Jim worked: 16
Total value of Jim's contribution: $800

TIPS

Financial Reports Should Be Easy to Use and Understand

Create reports that are easily digested. For reports that are produced regularly, using the telephone bill model can be useful. Start with a high-level summary of the information and offer more detail further into the report.

8.4 Monitoring Performance

Using financial statements to monitor performance can help ensure your organization remains financially sound. It is a good way to determine that you are not spending more than you take in, that you have sufficient reserves, and that you are operating efficiently.

Monitoring performance requires several key steps: produce and disseminate reports in a timely manner, review with common sense, make calculations and comparisons, think about contributing factors and ask for explanations, and develop an action plan.

Produce and disseminate reports in a timely manner. Establish routines for producing and disseminating all reports. The reporting cycle should be incorporated into the accounting procedures manual. If recipients are expected to discuss the reports at a meeting (for example, a board meeting or senior staff meeting), be sure to send the reports in advance. Once reports are produced, the period reflected on those reports should be closed to any further accounting adjustments. The system should lock out any efforts to post entries for a closed period.

Review with common sense. Several broad, commonsense questions should guide the review of financial statements. Does anything look off target? What needs explaining? What alternatives need to be developed? Does anything indicate potential fraud? (For example, are salaries much higher than budgeted without a detailed explanation?)

Make calculations and comparisons. Some basic calculations and comparisons, such as comparing current- and prior-period totals and balances, can help you interpret the organization's financial position. For example, consider trends in categories of expenditure, trends in revenue by type of funder, and trends in the number and size of grants and contracts.

> **Commonsense questions should guide the review of financial statements.**

Think about contributing factors and ask for explanations. Think about what factors or circumstances could have contributed to your organization's current financial position. Ask questions about anything that looks different from what was anticipated (for example, changes in staffing, changes in the funding environment, and changes in the demand for products and services).

Develop an action plan. Set goals for improvement. Develop an action plan for achieving those goals.

8.5 Interpreting Financial Statements

Rarely does a single ratio or point of comparison offer complete and reliable insight into your organization's financial health. Several different statistics and comparisons usually are necessary to obtain an accurate picture.

Several statistics and comparison measures can help you assess your organization's financial status, including growth rates, comparisons with previous years, and a review of sources and uses of cash. Other measures, such as the liquidity-current ratio, net profitability (total margin), or gross profitability (operating margin), can provide further insight. Following are details on how to calculate these statistics and comparison measures.

Growth rates. You should review growth rates regularly. This statistic shows whether various revenues are keeping pace with expenses. Such information can be generated easily from basic financial statements. To calculate growth rates, locate the relevant expense category on the income and expenditure statement (e.g., direct services, overhead, or fundraising) and divide the expense category by total revenue.

Ensuring that increases in expenses are occurring at the same time as appropriate increases in income is usually a wise course. Keep in mind, however, that the "right" percentage for growth rates depends on your organization's priorities.

Current year versus last year. This comparison, also known as rate of difference, is used to determine how sources of revenue and types of expenditures changed between periods. A simple comparison of financial statements from one year to the next can provide a wealth of information. To make this comparison, locate the current- and prior-year totals for revenue sources and expense categories on the income and expenditure statement. Then determine by how much each source or category went up or down.

PITFALLS

Financial Data Should Help, Not Overwhelm, Decisionmakers

Do not bury your managers in data. Give them the information they need to make good decisions. If they need more, they will ask for it.

No absolute rules of thumb exist for assessing the rate of difference. As part of the review, ask these questions:

- Are the increases or decreases dramatic?
- Was the difference planned?
- What factors contributed to the difference?
- Did unique expenses or revenues occur, such as emergency repairs or an unexpected donation?
- What revenues and expenses are stable over time?
- Are the revenue sources proportionate with expenses and vice versa?
- Are expenses in line with constraints governing restricted funds?
- How will you take this difference into account in developing budgets for next year?

Sources and uses of cash. This comparison is used to determine how cash flowed into and out of your organization. It provides another look at how well revenues and expenditures are aligned. To make this comparison:

- locate the net cash amounts for operating activities, investing activities, and financing activities on the cash flow statement;
- determine whether these totals are positive or negative; net cash from operating should be positive, while net cash from investing and financing may be negative;
- find total cash/cash equivalents and total accounts payable (same year) and determine which is greater; total cash/cash equivalents should exceed payables, because otherwise there are insufficient funds to pay bills; and
- compare total cash/cash equivalents in current and prior years and determine which is greater.

Again, no strict rules of thumb exist for this assessment. Ask questions such as these to help guide the review of this information.

- Were any differences planned?
- What might have contributed to the difference between total cash/cash equivalents in the current year versus the prior year?
- How does the difference affect future needs for cash?

The next three measures are used regularly by for-profit companies. Non-profits can also benefit from a review of these statistics.

Liquidity-current ratio. This statistic is used to benchmark your organization's ability to meet short-term obligations by providing information on the amount of cash on hand to meet obligations. To calculate the current ratio, locate total current assets and total current liabilities for a given year on the statement of financial position. Then divide the total of current assets by the total of current liabilities to get a ratio or decimal figure.

A ratio greater than one means the organization can cover current debt obligations. A general rule of thumb for your nonprofit is that this ratio should equal two (you have $2.00 for every $1.00 of liabilities that are due). Yet, depending on the nature of your organization's programs and activities, different ratios may be more realistic. For example, if your organization depends on complicated billing and reimbursement systems, it may require more cash on hand than organizations that collect fees for service.

Profitability (total margin). This statistic is used to benchmark your organization's operational performance and ability to expand. It offers another way to look at the variation between revenues and expenses. To calculate total margin, locate total revenue and total expenses on the income and expenditure statement and subtract expenses from revenue. Then, divide the result by revenue.

A higher ratio shows a better performance. Profitability is important for any type of organization; nonprofit organizations should not operate at a loss. Cash is necessary for investment purposes, innovation, and expansion. The right profitability ratio depends on your organization's goals. Yet you should not operate at too high a profit margin; this would indicate a failure to provide adequate programmatic returns on revenues.

DEFINITIONS

Liquidity:

Liquidity refers to the ease with which assets can be converted into cash. Obviously, cash has the most liquidity. Real estate has much less liquidity.

Profitability (operating margin). This statistic is used to benchmark your organization's ability to cover its program costs from operating revenue, instead of having to rely on grants and external funders. Many nonprofit organizations rely on revenues from outside sources to cover the cost of operations. Profitability shows how much fundraising is necessary. To calculate operating margin, locate total operating revenue (the income from fees paid by clients) and total operating expense (what it costs, without overhead, to run a program) on the income and expenditure statement. Next, subtract total operating expense from total operating revenue. Then, divide the result by total operating revenue.

A higher ratio means your organization can meet its operating budget without relying on revenue from other sources. There is no one-size-fits-all standard; the board and executive director must consciously and deliberately decide what operating margin to employ.

The financial statements of your organization carry substantial weight and can have significant impacts on decisions made at all levels of the organization. You and your lead finance manager are responsible for the fair presentation of information in your reports, including financial position and changes in net assets and cash flows, and ensuring all reports are in conformity with generally accepted accounting principles.

Additional Resources

For more information on interpreting nonprofit financial statements, see S. Berger, *Understanding NonProfit Financial Statements* (Washington, D.C.: BoardSource, 2003).

For more information on Federal Accounting Standards Board Statement Number 117, see The Non-Profit Resource Center, "Analysis of FASB 117" [2006], at: www.1800net.com/nprc/fasb117.html.

For more information on calculating the value of volunteers' in-kind contributions, see Susan Ellis, "The Dollar Value of Volunteer Time" [May 21, 2007], at: www.energizeinc.com/art/afoc2.html. The Independent Sector provides estimates for volunteer time at www.independentsector.org/programs/research/volunteer_time.html.

Sample Budget Variance Report

Hubbard Street Youth Voice Year-to-Date Budget / Month 6 of the fiscal year

REVENUES	Annual Budget	Year-to-Date Budget	Year-to-Date Actual	Year-to-Date % Variance	Year-to-Date % Variance
Contributed Revenues					
Government Grants (State)	20,000	10,000	8,000	80%	(2,000)
Government Grant (County)	50,000	25,000	22,000	88%	(3,000)
Foundation Grants	70,000	35,000	37,000	106%	2,000
Corporate Gifts	60,000	30,000	22,000	73%	(8,000)
Individual Contributions	15,000	7,500	5,000	67%	(2,500)
Direct Mail	5,250	2,625	3,000	114%	375
Fundraiser	25,000	12,500	0	0%	(12,500)
Total Contributed Revenues	**245,250**	**122,625**	**97,000**	**79%**	**(25,625)**
Earned Revenues					
Space Rentals	10,000	5,000	2,300	46%	(2,700)
Fees for Services	5,000	2,500	1,000	40%	(1,500)
Asset-Generated Income	1,200	600	605	101%	5
Total Earned	**16,200**	**8,100**	**3,905**	**48%**	**(4,195)**
TOTAL REVENUES	**261,450**	**130,725**	**100,905**	**77%**	**(29,820)**

EXPENSES					
Personnel					
Salary and Fringe	170,000	85,000	80,000	94%	(5,000)
Computer Consultant	8,000	4,000	2,500	63%	(1,500)
Payroll Service	5,000	2,500	2,500	100%	0
Accountant	10,000	5,000	4,500	90%	(500)
Professional Development	10,000	5,000	7,000	140%	2,000
Total Personnel	**203,000**	**101,500**	**96,500**	**95%**	**(5,000)**
Other Expenses					
Transportation	10,000	5,000	7,500	150%	2,500
Curriculum Cost	7,000	3,500	6,000	171%	2,500
Program Supplies	5,000	2,500	2,000	80%	(500)
Office/Classroom Space	7,500	3,750	4,000	107%	250
Utilities and Insurance	2,500	1,250	1,250	100%	0
Fundraising Expenses	10,000	5,000	5,500	110%	500
Office Supplies	2,500	1,250	750	60%	(500)
Postage	4,000	2,000	1,900	95%	(100)
Dues & Fees	1,000	500	250	50%	(250)
Telephone	5,000	2,500	3,000	120%	500
Copier Lease	3,000	1,500	1,500	100%	0
Bank Charges	750	375	300	80%	(75)
Total Other	**58,250**	**29,125**	**33,950**	**117%**	**4,825**
TOTAL EXPENSES	**261,250**	**130,625**	**130,450**	**100%**	**(175)**
Net Surplus (Deficit)	**200**	**100**	**(29,545)**		**(29,645)**

Sample Balance Sheet

December 31, 2000 and 1999

ASSETS	2000	1999
Current Assets		
Cash and cash equivalents	24,088	27,259
Short-term investments	90,000	55,000
Unconditional promises to give:		
Unrestricted	1,650	4,500
Restricted to program	1,550	300
Accounts receivable	650	489
Prepaid expenses	4,337	2,189
Total Current Assets	122,275	89,737
Fixed Assets		
Property and equipment, net of accumulated depreciation	18,846	23,629
Total fixed assets:	18,846	23,629
Total Assets:	141,041	113,366
LIABILITIES AND NET ASSETS		
Current Liabilities		
Accounts payable	19,114	13,699
Accrued liabilities	1,431	937
Deferred revenue	12,000	17,000
Total current liabilities	32,545	31,636
NET ASSETS		
Unrestricted	28,496	16,430
Restricted	80,000	65,300
Total net assets	108,496	81,730
Total liabilites and net assets:	**141,041**	**113,366**

Adapted from “Understanding Nonprofit Financial Statements,” John Paul Dalsimer.

Sample Review Checklist

General Ledger

Preparer	Reviewer	
		Check general ledger for accuracy

Balance Sheet

Preparer	Reviewer	
		Is the date correct
		Is statement consistently formatted
		Do Assets equal Liabilities and Fund Balance
		Does each donor's fund balance match their respective Revenue, Expenses, and Fund Balance Report
		Does the consolidated fund balance match Consolidated Revenue, Expenses, and Fund Balance Report

Statement of Revenue, Expenses and Fund Balance

Preparer	Reviewer	
		Is the date correct
		Is statement consistently formatted
		Does the ending fund balance match the Balance Sheet's
		Are the budget variance percentages correct

Work papers include Trial Balance, Trial Balance for sub accounts and MTD General Ledger.

Preparer Date

Reviewer Date

Transmitted / E-mailed Date

Chapter 9 Conducting an Audit

Although the thought of an audit can be stressful, with proper preparation the auditing process can be a great opportunity to keep your organization's fiscal management systems in top shape. The process is a chance to verify the accuracy of your organization's financial information and lend credibility to your financial reports. An audit can also help your organization identify areas and strategies for improvement.

9.1 Audits

An audit is a process of using outside, independent experts to test the accuracy and completeness of information presented in your financial statements. During this process, auditors want to know whether the accounting practices conform to accounting standards and are fair, complete, objective, and accurate.

At the end of the audit, auditors express a written opinion about the fairness and accuracy of your financial statements as well as produce a report to your board of directors. The opinion renders a judgment about whether the statements follow accounting standards and fairly and accurately reflect the financial status of your organization.

How to Achieve a Clean Audit

For a clean, "no problems" audit:

- avoid conflicts of interest—board members, staff, and relatives should not conduct audits;
- build audit costs into the budget to ensure the audit will happen;
- act on all audit findings; and
- prepare for an audit throughout the year.

9.2 Purposes of an Audit

Generally, audits are conducted for five main reasons:

- to fulfill fiduciary responsibilities to your organization's leaders and board members, foundations, and donors;
- to meet terms and conditions in grants and agreements with government agencies and other funders;
- to comply with federal or state guidelines;
- to strengthen your organizational capability by enacting improvements in accounting processes and controls recommended by the auditor; and
- to signal organizational maturity by providing evidence of your organization's internal capability and commitment to adhere to generally accepted accounting principles and standards.

In addition, audits provide your organization with credibility of financial statements, advice on internal controls and other management issues, and assistance in tax reporting and compliance requirements.

- **Credibility of financial statements.** Audited financial statements are more accurate and more meaningful to your funders, board members, and staff.

Creating an Audit Committee

Your board of directors should create an audit committee to oversee accounting practices and audits for your organization. Such a committee typically consists of several board members and at least one financial expert. The audit committee should be separate from the finance committee. An important job for the audit committee is selecting the auditor. See the section 9.3 for more information on how to choose an auditor.

Engage your audit committee early in the audit process and make sure that they thoroughly understand the issues that may come to light during the audit. This may require you to provide training for the committee.

The work of the audit committee does not end when the audit is completed. The committee should carefully review the audit, especially the recommendations of the auditor. Based on those recommendations, the committee should create and execute a work plan to strengthen the organization's fiscal management systems if necessary.

- **Advice on internal controls and other management issues.** Independent auditors point out issues concerning internal systems, which can lead to valuable changes in how your organization and staff operate.
- **Assistance in tax reporting and compliance requirements.** To maintain a tax-exempt status, your nonprofit organization must provide audited reports.

Your organization may choose to conduct an independent audit annually or every other year. How your board decides to audit its finances will depend on the requirements of grants and funders, regulatory guidelines, and your organization's resources and capabilities.

9.3 Working With an Auditor

An audit aims to determine whether financial statements conform to accounting principles and are fair and accurate. Your organization will need to select an independent auditor, such as a certified public accountant (CPA) or accounting firm, to conduct the audit. Auditors analyze financial data, including hard-copy files; review written procedures; and conduct staff interviews to investigate your organization's accounting practices. They look for evidence that policies and controls exist and are working properly.

Look for auditors with:

- experience with similar organizations;
- good references;
- an interest in serving your organization; and
- reasonable fee structures.

Independent audits can be time consuming. The key to a smooth audit process is preparation. Prepare for the audit throughout the year, with special attention focused on preparing all the requested documents one month prior to the audit. Be sure to inform staff about the audit process, the timing of the audit, and their role in the process.

The auditor will likely visit your organization's offices. Prepare for the auditor's visit by setting aside physical space for him or her to work. Have the

PITFALLS

Pay Attention to the Auditor's Opinions

Do not dismiss the auditor's opinions. His or her expert advice could end up saving your organization considerable time and money.

appropriate management people available to answer questions and provide needed information. The auditor is likely to produce a steady stream of detailed requests.

Auditors test accounting practices to determine how the organization is tracking revenues, expenditures, and cash transactions. They evaluate whether your organization records its revenues in the correct:

- amount;
- period;
- category; and
- restricted/unrestricted classification.

They determine whether your organization's expenses are:

- classified by project and function;
- recognized in the correct period;
- justified with supporting receipts and invoices;
- projected accurately (actual versus budgeted), and
- reflected correctly in terms of overhead allocation.

Auditors also test fiscal management procedures and controls to ensure reliable financial data, make sure your organization is complying with laws and regulations and ensure efficient operations.

The key to a smooth audit process is preparation. Prepare for the audit throughout the year, with special attention focused on preparing all the requested documents one month prior to the audit.

After their investigation, auditors render an opinion about whether your financial statements follow accounting rules and accurately reflect your organization's financial status. Auditors offer three types of opinions: unqualified (meaning "all is well"), qualified (meaning things are generally well within your organization, with some exceptions), and adverse (meaning there are serious problems to address).

TIPS

Audits Focus on Financial Management Controls

Remember that auditors will be assessing whether your nonprofit organization has the necessary financial management controls, including:

- controls for cash and noncash receipts;
- controls for cash and noncash disbursements;
- controls for payroll; and
- controls for investments.

Auditors also submit a report to your board of directors. The report usually includes:

- a cover letter addressed to your board of directors from the auditor (includes opinion);
- audited financial statements, usually prepared by your treasurer or staff; and
- notes to financial statements, which provide supplemental information on accounting policies and specific items in the statements.

An A-133 Audit

If your organization spends $500,000 annually in total federal funds, including federal funds that have passed through state or local government agencies, it must submit to a more detailed type of audit. This audit, performed by a certified public accountant, is described in OMB Circular A-133 and is usually referred to as an A-133 audit. A-133 audits are frequently more costly and time consuming than "regular" audits.

9.4 Alternative Audits

Your organization may decide not to conduct a full independent audit each year, especially if it is young or very small; the reasons likely relate to cost and time. An internal audit and a financial review are important alternatives. These alternatives can verify the financial status of your organization, provide accountability, and help prepare your organization for future audits.

Internal audit. An internal audit aims to ensure that routines and practices are working as planned. It can help you determine whether your organization's accounting system collects, measures, and synthesizes transactional data correctly. An internal audit follows steps similar to those in an independent audit, such as verifying financial records and fiscal procedures, and it documents its findings.

Your organization's staff will typically conduct the internal audit. Depending on the size of your organization, this will be the financial officer and/or senior staff. Very often, CPAs participate at critical junctures to ensure accountability and lend objectivity and expertise. Although an internal review can be quicker and less expensive, it lacks the objectivity and credibility of an outside audit.

Financial review. A financial review, also known as a CPA review, is less formal and intensive than an independent audit. Independent auditors, usually CPAs, conduct financial reviews. The CPA serves as a "critical friend" to your organization by testing selected procedures and controls and making recommendations for improvement. He or she can also serve as a resource in developing your annual financial statements.

A financial review aims to test and strengthen your organization's capability. The CPA tests accounting practices and financial controls and makes recommendations for improvement. He or she works with your staff to verify transactions; reconcile accounts and statements; ensure proper documentation (for example, receipts, invoices, and vouchers); review contracts and grants; check for appropriate controls and procedures; and finalize annual financial statements. Although financial reviews do not offer a formal auditor's "opinion" on the financial health of your organization, the review should record the findings and make recommendations tailored to your organization.

A financial review is a good precursor to a full audit. If your organization does not have the resources or capability to undergo a full audit, the financial review is a good alternative.

Additional Resources

For more information on creating an audit committee for a nonprofit, see American Institute of Certified Public Accountants, *AICPA Audit Committee Toolkit: Not-for-Profit Organizations* (New York, N.Y.: American Institute of Certified Public Accountants, 2005), at: www.aicpa.org/Audcommctr/toolkitsnpo/homepage.htm.

For more information on audit committees in nonprofits, see Grant Thorton, LLP, *Audit Committee Handbook for Non-Profit Organizations* (Chicago, Ill.: Grant Thorton, LLP, 2005), at: www.cpaspi.org/cpaspi/resources/NFPAC-Booklet.pdf.

For more information on typical audit committee responsibilities, see www.ncna.org/_uploads/documents/live/checklist.doc.

For more information on controlling audits in nonprofits, see H. Rentiera, *Controlling the Audit Process* (Chicago, Ill.: CPAs for the Public Interest, 2000), at: www.cpaspi.org/cpaspi/pdf/auditprc.pdf.

For more information on single audits, see W. Ruppel, *Miller Not-For-Profit Organization Audits with Single Audits*, 2005–2006 (Chicago, Ill.: CCH Incorporated, 2005).

Chapter 10

Complying with Sarbanes-Oxley and the Revised IRS Form 990

Scandals in corporate finance and increased public interest in accountability have lead to more government oversight of nonprofits. Two ways that this oversight is exercised are the Sarbanes-Oxley Act and the revised IRS Form 990.

10.1 The Revised IRS Form 990

IRS Form 990, or "Return of Organization Exempt from Income Tax," is the annual report to the Internal Revenue. This return is due on the 15th day of the 5th month after the end of the fiscal year. For example, organizations whose fiscal year ends on June 30th must file by November 15th of that year. The recent revisions are meant to enhance the transparency of tax-exempt organizations to the IRS and the public as well as promote compliance with applicable tax laws.

The revision is extensive. Nonprofits are required to divulge more information in many areas, including:

- **Governance and management structures.** Organizations are asked a variety of questions about how they are governed, including the number of voting members, significant changes to organizational documents such as governing by-laws, and the keeping of written minutes of meetings.
- **Board composition and the level of board independence.** Organizations must describe the family or business relationships between officers, directors, trustees and key employees. These relationships must be detailed in an attached schedule, including listing any and all loans and grants, as well as business transactions over $10,000.
- **Compensation of key employees.** The revised Form 990 requires information about compensation, not only about current officers, directors and key employees but also about former people in those roles as well as current independent contractors. Very specific questions are asked about the kinds of compensation, including payments for housing, first-class travel and travel for companions. Organizations are also asked to describe their process for determining executive compensation.

Important note:

The final version of the new form was not available at the time this guide was published, so check the IRS web site listed at the end of this chapter for the latest information.

- **Creation of written policies.** The Sarbanes-Oxley Act requires that organizations have written policies for document destruction and whistle-blower protection. (See the section below for more on Sarbanes-Oxley.) The revised Form 990 asks about those two policies as well as about the existence of other written policies including those regarding joint ventures and conflicts of interest.
- **Disclosure of your Form 990.** The IRS requires your organization to keep its 990 filings from the three previous years available to the general public. In the revised form, you must explain how your organization does this.

10.2 Preparing the Revised Form 990

The changes to the Form 990 mean that your organization will have to change how it prepares the form. Consider these elements as you plan your work.

- **Assemble a team to coordinate the effort.** The information asked for by the revised Form 990 is more than just numbers. Numbers do still play a large role, but there are also statements on activities and governance. In past years, the lead finance manager of a small nonprofit could complete the form with only minor assistance from other managers. Because of the demands for deeper data and increased requirements for narrative, creating a team of internal personnel, plus external support such as an accountant, is a good idea for at least the first year that you file. Depending on the demands of the revised Form 990, you may need an entirely new outside preparer for the form
- **It's a year-round process.** Like all of your organization's other reporting efforts, the preparation of Form 990 should be worked on year-round. There are many possible additional schedules of the Form 990 that you may have to file, depending on your organization's activities and

TIPS

Form 990 EZ or Not?

Depending on your organization's revenues and assets, it may be eligible to file the simpler Form 990 EZ. The standards for eligibility will be changing from tax year 2007 to 2010, so be sure to check the IRS regulations to determine whether your organization is exempt from filing the full Form 990.

PITFALLS

Consider how your Form 990 will be perceived by outside audiences such as potential collaborators or funders.

- Do your finances look healthy?
- On the checklist of required schedules, are potentially controversial responses about political campaigning, lobbying or excess benefits explained?
- Will your organization's fundraising expenses be perceived as being too high?
- Are there conflict of interest issues, such as loans or business relationships between officers and directors?

status. Get familiar with the ones that apply to you and begin gathering information early. As was mentioned above you will need to describe your board's independence and relationships. You are far more likely to have a complete and accurate record of this if you track changes and transactions as they happen over the course of the year rather than trying to go back and re-create these after the fact. Your board members will appreciate knowing ahead of time what you plan to share with the IRS.

- **Review or create policies.** Preparing the revised Form 990 can be an opportunity to help keep your organizational house in order. Take this time to review all the written policies required by the Form 990 or if need be, create them. As your organization ages and evolves, its policies should evolve with it.

The new requirements of the Form 990 mean that your organization is open to a new level of scrutiny. In an age when Form 990s are easily available at web sites like www.guidestar.org, the Form 990 is more than just another reporting obligation. It is a public relations tool that can help or hurt your organization. Schedule O (Supplemental Information to Form 990) gives your organization an explicit opportunity to tell its story, but there are narrative opportunities throughout the form. Be completely honest, but make sure that readers understand how your organization is doing good work.

10.3 The Sarbanes-Oxley Act

Following the collapse of Enron and WorldCom, Congress passed the Sarbanes-Oxley Act in 2002. Only two parts of the law specifically apply to both nonprofit and for-profit organizations: a protection for whistleblowers and a prohibition against destroying documents related to litigation. The act's other provisions deal with good financial accountability practices in for-profit organizations, focusing on the board's responsibilities as the governing body such as having an audit committee, requiring financial reports to be certified, banning personal loans to executives, and increasing financial disclosure requirements. Nonprofits are also advised to adhere to these provisions. The movement begun by the Sarbanes-Oxley Act could lead to more stringent nonprofit accounting standards. This federal law has already motivated several states, including California, Massachusetts, and New York, to consider legislation that would increase financial accountability in nonprofit organizations.

Whistle-Blower Protection

The Sarbanes-Oxley Act provides protections for whistleblowers and imposes criminal penalties for actions taken in retaliation against those who risk their careers by reporting suspected illegal activities in the organization. It's illegal for any entity — for-profit and nonprofit alike — to punish the whistleblower in any manner.

Because illegal activities often involve finances, as the lead finance manager it's essential that you clearly communicate the policy to employees and board members. A good whistleblower policy includes the following:

- A detailed list of who is covered by (and accountable to) this policy. This should include all staff and board members.
- The procedure for whistleblowers to report illegal activities. It should include multiple, separate paths for confidential reporting. If your organization's only process is to report all wrong-doing to the chair of the board, that does not help if the chair is one being reported on.
- An explanation of the investigation and resolution process, including an appeals process.

Implementation of Whistleblower Protection

Having a well-crafted policy is a good start, but it only works if the organization implements it and managers lead by example. Once the policy is created, train the staff and board on it and have all participants sign memos saying that they understand it. Organizational leaders must adhere to the principals of anonymity and confidentiality in any investigations and of course, exercise no retaliation. Above all, all participants must act in good faith, putting the interests of the organization and public good above all others.

Document Destruction

The Sarbanes-Oxley Act addresses destruction of litigation-related documents. The law makes it a crime to alter, cover up, falsify, or destroy any document (or persuade someone else to do so) to prevent its use in an official proceeding (e.g., federal investigation or bankruptcy proceedings). The law extends to destruction of documents in situations where cases are only being contemplated but have not yet begun proceedings.

Implementation of Document Destruction Policies

Because of these restrictions, the Act turns intentional document destruction into a process that must be monitored, justified, and carefully administered. Work with your human resources manager and your information technology manager to create a written, mandatory document retention and periodic destruction policy, which includes guidelines for electronic files and voice-mail. As with the whistleblower policy, train your staff and board on the new processes and have them sign off saying that they understand the policy. If an official investigation is underway or even suspected, stop any document purging in order to avoid criminal obstruction charges.

One final word of advice: In all legal and financial matters in your organization, be sure to confirm your organization's significant decisions with a lawyer and/or an accountant.

Additional Resources

For information from the Internal Revenue Service, go to http://www.irs.gov/charities/topic/index.html.

For sample guidelines on document destruction, see the National Council of Nonprofit Associations website at www.ncna.org.

For more information on whistleblower protection policies, see the BoardSource website at www.boardsource.org.

Chapter 11

Sharing a Few Final Reminders

Although creating and operating financial management systems might be considered the least glamorous tasks of running your nonprofit, they are absolutely essential to ensure your organization achieves its mission. As a manager of a youth-serving organization that builds and administers these critical systems, keep in mind this advice culled from the previous chapters of this guide.

Ensure the budget reflects and supports your organization's mission and vision.
Once the board develops and approves your organization's budget, departing from it can difficult. Be clear about program strategies for the coming year before the budget process begins.

Ask for help from seasoned practitioners to avoid problems early on.
Board members or other friends of your organization can often easily find a volunteer with finance experience. Or, your organization should seek the advice of a CPA and/or other experts.

Craft user-friendly financial management systems.
Your lead finance managers may be tempted to create financial management systems that simplify their jobs while making the jobs of program managers more difficult. Creating systems that both maintain financial integrity and support program operations is possible. Resist unnecessary complexity.

Set policies and procedures, then stick to them.
Whether it is reporting revenue, hiring a new staff person, or issuing petty cash, sticking to established financial management controls will ensure good recordkeeping, demonstrate fairness, and avoid fraud. Consistent execution of these policies and procedures is the ally of financial integrity.

Recognize the difficult role your lead finance manager must play.
Often it is the role of this person to say no. Much misunderstanding and emotional distress can be avoided by clearly articulating not only your financial policies and procedures, but also the reasons behind them. If your lead finance manager has created goodwill by setting up user-friendly financial management systems, conflicts are less likely to happen.

Integrate financial management systems with the rest of your organization.
Financial management systems are part of the larger administrative systems of your organization, which include fundraising, human resources, and participant enrollment. If you have a good lead finance manager, he or she will understand the need to connect the financial management systems to the rest of your organization and foster good relationships with other functional areas as much as possible. Quality financial management systems are the result of teamwork.

Much misunderstanding and emotional distress can be avoided by clearly articulating not only your financial policies and procedures, but also the reasons behind them.

Get regular audits.
The costs incurred to conduct an audit are a fraction of what could be lost in terms of time, money, and goodwill should an embezzlement case arise. Audits are the best—though not the only—guarantee of your organization's financial integrity.

As a leader of a nonprofit youth-serving organization, you face complexity and challenges. Following the guidelines and suggestions in this guide will help reduce that complexity and enable you to focus on the challenges—and satisfactions—presented by mission and operations.

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About The Finance Project

Helping leaders finance and sustain initiatives that lead to better futures for children, families, and communities.

The Finance Project is an independent nonprofit research, consulting, technical assistance, and training firm for public- and private-sector leaders nationwide. It specializes in helping leaders plan and implement financing and sustainability strategies for initiatives that benefit children, families, and communities. Through a broad array of tools, products, and services, The Finance Project helps leaders make smart investment decisions, develop sound financing strategies, and build solid partnerships. To learn more, visit www.financeproject.org.

Sustaining and Expanding Youth Programs and Policies

This publication is part of a series of tools and resources on financing and sustaining youth programming developed by The Finance Project with support from Underage Tobacco Prevention: Philip Morris USA, an Altria Company. These tools and resources are intended to help policymakers, program developers, and community leaders develop innovative strategies for implementing, financing, and sustaining effective programs and policies. To access these resources and for more information on this project, see www.financeproject.org/special/irc/youth_about.cfm

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