

Table of Contents

The Board of Directors	1
Budgeting	4
Bookkeeping	8
Internal Financial Reporting	17
Cash Flow Management	20
Internal Control	23
Federal and State Reporting Requirements	27
Appendix A- Bookkeeping Basics	32
Sample Chart of Accounts	32
Sample Cash Receipts Journal	34
Sample Cash Disbursements Journal	35
Sample General Journal Entries	36
Sample General Ledgers	37
Appendix B- Internal Financial Reporting	42
Sample Bank Reconciliation	44
Treasurer's Report	45
Appendix C- Cash Flow Management	46
Schedule of Projected Receipts And Disbursements	46
Projected Cash Flow	47
Actual Cash Flow	48
Appendix D- Internal Control	49
Internal Control Checklist	50

The Board of Directors

Choosing Members of the Board

Serving as a director of a nonprofit organization has often been regarded more as an honorary title than a task-oriented commitment. Until recently, many nonprofit boards did not hold regular meetings and were not actively involved with the policies and operations of the organization.

As the nonprofit sector gains a more independent position in the economy, directors are called upon to wield professional management skills and help further the group's goals.

A Board member should believe in the organization, have a commitment to its goals and a sincere willingness to make those goals become reality. Even though some of directors are selected because of the influence they bring to the organization, they should be willing to take an active role in managing it. Individual directors' energies should be channeled in their respective fields of specialization. Often, the most appropriate way to select directors is by considering those management talents which the board lacks and seeking individuals offering those specific qualities.

Board Responsibilities

Among the primary responsibilities of any board member is acting as a steward of the organization's finances. Since the director manages money raised through public support, he/she should assure the funds are spent to further the program goals in the community interest. To fulfill this mandate, directors must effectively oversee the operations.

Directors should understand and prioritize the goals of the organization in a mission statement. Short and long range plans which assess how goals are to be achieved should be developed. Directors should regularly assess the viability, effectiveness, and cost-efficiencies of the program activities and service delivery systems. At least annually, if not more often, these plans should be evaluated against the mission statement.

Beyond establishing policy and setting program priorities, board members should assure there is an effective staff and adequate organizational structure in place. While directors should review the results of day-to-day operations, they should not become overly involved in them.

In addition, the board is responsible for assuring compliance with all relevant federal, state and local governmental regulations, and reporting or other requirements of funding sources.

Meetings of the board should be held regularly, they should be well-organized, an agenda should be presented and minutes should be distributed and approved.

Finally, members of the board must be concerned with the board's continuity and the perpetuity of the organization. Hence, selection of new board members is important. Of course, fundraising is another priority, with various directors participating actively.

Audit Committees

It is highly advisable for a nonprofit organization, especially when raising funds from the general public, to form an audit committee as a separate entity or an arm of the finance committee. The audit committee should include – or work very closely with – the board treasurer, and should consist of those board members most suited to learn about and interpret financial information. A Committee of three to five members is large enough to provide a diversity of views and is small enough to be effective.

This committee is responsible for choosing an independent auditor each year and assuring—directly or indirectly—that the organization's books are prepared for the audit process. The committee should meet with the auditor before the audit begins and assign relevant staff responsibilities when appropriate.

When the audit is completed, the committee should carefully review and approve the organization's financial statements and review the auditor's internal control/management letter. The financial should then be presented by the committee to the full board of directors for approval.

The audit committee has responsibility for responding to suggestions contained in the auditor's internal control/management letter. The committee should assure that all approved changes are implemented to the best of the organization's ability.

If an organization's books are not audited at the end of the year, the audit committee's functions should be performed by incorporating them into the board's finance committee.

In any event, it is critical that the board remain informed of the organization's financial matters. This can be done by formalizing procedures for continuing, open communications with the organization's independent accountants.

Budgeting

Why Budget?

Not Unlike a for-profit business, the board of directors of a nonprofit organization retains a stewardship responsibility. The directors are charged with establishing policy to achieve the mission, procuring necessary resources, overseeing operations and planning future directions.

The directors should create or update a master plan of yearly activities reflecting the short and long range goals at least annually. The board should review the program and articulate the organization's commitments.

As stewards of the organization's finances, the directors are accountable to the general public for assuring funds are used to further the organization's charitable purpose. The board must responsibility guide the organization along a carefully selected path, consistent with the program outlined to the contributors.

Budgeting is an integral part of managing and planning for the future of any organization. Budgeting must be regarded as essential to ongoing operations so the organization sustains its ability to provide its services. It is very important that budgeting be done with the goals and activity plan clearly in mind.

Planning for Budgeting

Planning always involves uncertain events and conditions. Adequate time should, therefore, be allocated for budgeting to consider the many factors that may influence the year. Planning should begin several months before actual budget preparation begins.

Past performance is usually a good indicator of future performance, and thus the prior year's budgets and financial statements are valuable. An indispensable budgeting aid is the prior year's financial statements which compares budget with actual revenues and expenses, item by item. It may also be helpful to review a year-to-date financial statement and compare it with the budget.

As the future is always uncertain, budgeting may seem like guessing. Like any other skill, dexterity and ease will come after repeated practice and close attention to feedback. Feedback should come from reviewing budgeted and actual revenues and expenses, and from staff who feel the appropriations for some categories are inadequate.

As part of budget planning, the chart of accounts in use should be relevant, comprehensive and sufficiently informative. (See sample Chart of Accounts in Appendix A.)

Planning for the budgeting process is the first step in creating the budget. Like any other outcome that is desired, it must be programmed to happen.

Who prepares the Budget

An organization's budget should be prepared by someone with a good working knowledge of the finances. Ideally, a committee of the board should translate the master plan of activities into the coming year's revenues and expenses. The president of the board, the executive director, board members and staff possessing adequate accounting skills and knowledge should belong to this committee. At the very least, the treasurer, a member of the finance committee, or someone with a strong business background should be chosen for the task. Since staff members are most closely involved with spending patterns, it may be more efficient to have them draft a tentative budget.

The annual budget must be carefully reviewed and approved by the board of directors. The directors must keep in mind the short and long range goals of the program, the fundraising strategies, and spending limitations.

How to Prepare the Budget

Once the committee has been given responsibility for budget preparation, all materials relevant to the task should be gathered. These related documents include but are not limited to: the prior year's budget (if available); the prior year's financial statements; recent monthly internal financial statements; organizational journals and ledgers; and the board's statement of short term goals.

After this information is carefully studied, the amounts to be budgeted must be considered, item by item. Use budget categories that correspond to the chart of accounts and the financial statements so comparison is meaningful. For each item, consider the following:

- What was last year's budgeted amount for this item?
- Looking ahead, what are the minimum and maximum amounts that can be reasonably estimated, considering inflation and potential funding source cutbacks?
- What are the requirements of the activity plan projected for the year ahead?

The first draft of the budget may indicate a range of numbers or an estimated amount for each category. When all categories have been considered, the revenues and expenses should be totaled. Usually it takes magic or great good fortune for the total revenues to equal the total expenses the first time!

The next step is to revise this first draft into a budget ready for board approval. Ideally, total revenues should equal total expenses, and therefore some juggling and

organizing of priorities may be necessary. The preparer's experience and intuition is needed to introduce a degree of flexibility in estimating.

At times, the board may approve a "deficit" budget—i.e. total expenses would exceed total revenues—but such a course should only be taken after careful consideration of the long range impact on the program. When completed, the budget document should represent a fair, reasonably accurate, and realistic picture of revenues to be raised and anticipated spending.

Evaluating the Budget

Although nonprofit organizations have to work with their funding limitations, the budget should not be seen as a restrictive device. Rather, it is a way of estimating and guiding the spending of program resources.

The budgeting process is not complete until a careful evaluation of the effectiveness of the annual budget is made. One needs to examine how closely the budget predicted the reality of the year's revenues and expenses. Differences should be noted and considered in the preparation of future budgets.

Contingency Planning

Once the budget is finished, it is useful to prepare a contingency budget outlining actions to be taken if actual funding is less than planned. This budget is most useful to an organization soliciting from the general public or one whose funding is not substantially assured at the outset of the year.

A contingency budget is merely a budget revised on the basis of the assumption that the level of funding generated will be lower than was planned—e.g. 10% or 20% less. This process allows the board and management to focus on the organization's service priorities and determine the actions that can be taken to balance the budget in an organized, unpressured environment.

Bookkeeping Basics

Key bookkeeping Concepts

To understand the intricacies of bookkeeping, it is helpful to have a grasp of some fundamental concepts pertaining to the theory of financial accounting. Although a set of financial books can be kept without a grasp of underlying concepts, the practice will be more pleasant if the overall structure and flow of financial information is understood.

Some of the key Bookkeeping concepts are:

Completeness- a good bookkeeping system is one that will allow the recording of all financial transactions in the books.

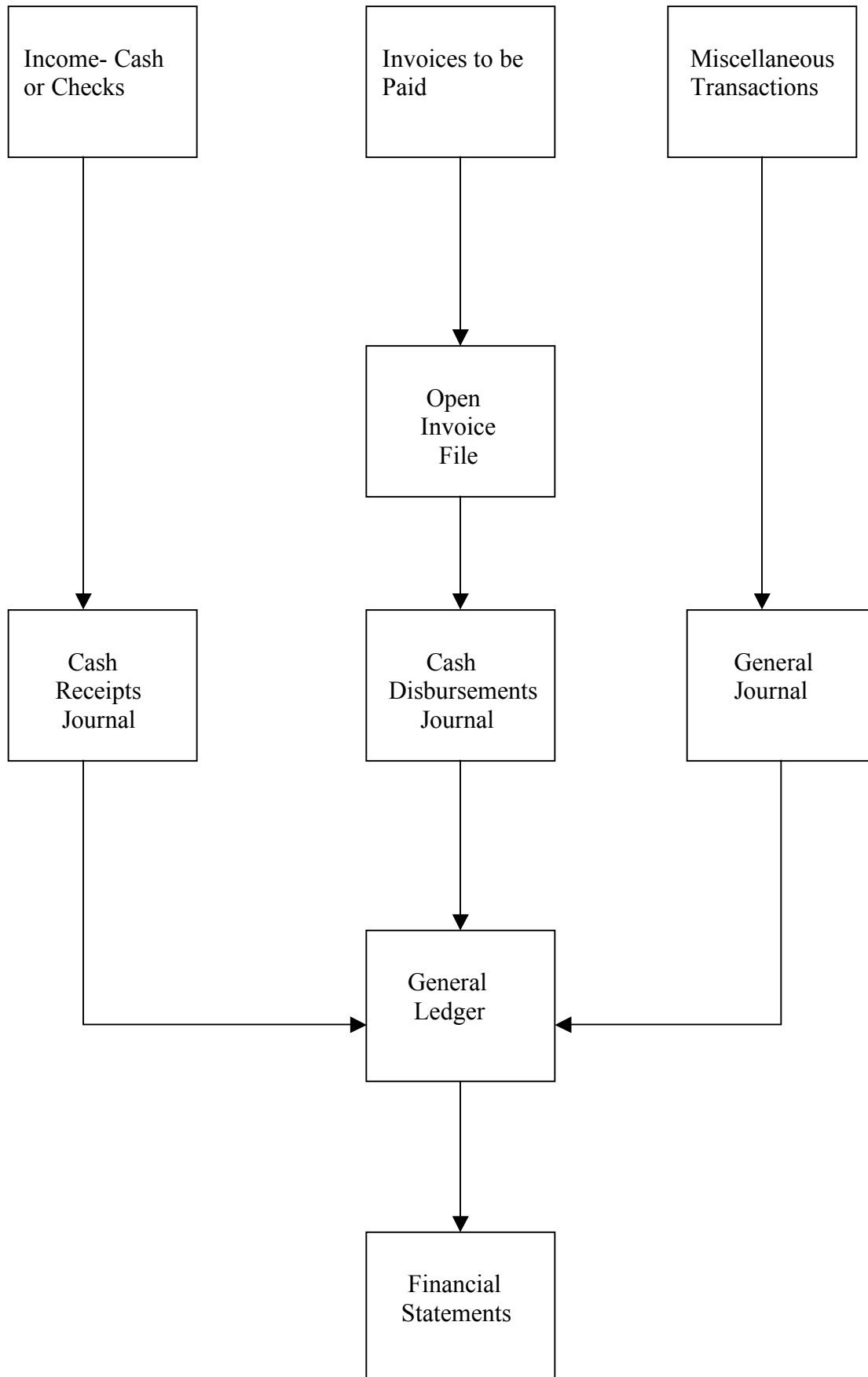
Self-checking- because it uses debits and credits, bookkeeping intrinsically involves double-checking the work done, and a good bookkeeping system contains methods of cross-checking and verifying. One key to keeping books is understanding and using cross-checks often.

Double-entry system- the double-entry system is based on debits and credits. This way, there are at least two parts to any financial transaction, or two accounts in the books that are affected by any financial event. Total debits always equal total credits. For example, the receipt of cash as a donation affects the cash account (by increasing it) and the total amount of donation income for the year (again, by increasing it). Also, the payment of a telephone bill affects the cash account (by decreasing it). The use of a double-entry system assures that total debits always equal total credits. Thus, the books are “in balance”.

DEBIT	ACCOUNT	CREDIT
Increases	Asset	Decreases
Decreases	Liability	Increases
Decreases	Fund Balance	Increases
Decreases	Revenue	Increases
Increases	Expense	Decreases

Organization- an efficient bookkeeping system is organized so financial information flows logically from beginning points (e.g., invoices to be paid) to the final result- the financial statement. (Refer to the chart on page 10). Each financial transaction should be clearly shown in the books and traceable through the system.

FLOW OF FINANCIAL INFORMATION



Cash, Accrual, and Notified Accrual Basis Bookkeeping

There are three methods of bookkeeping from which a non-profit organization can choose to structure its system: cash, accrual, or modified accrual. Generally accepted accounting principles require the accrual method in the presentation of financial statements; however, it is often practical to maintain the books on a cash or modified accrual basis and make adjusting entries for financial statement presentations.

Cash Basis bookkeeping is the simplest method, and the most widely used by small nonprofit organizations. Revenues are recorded in the cash receipts journal only when they are actually received, and expenses are recorded in the cash disbursements journal only when the money is actually spent.

With the **accrual** method, all income is recorded in the books when it is earned or receivable, regardless of when it is actually received. Expenses are recorded when they are incurred, regardless of when they are actually paid. The accrual method is used by those nonprofits which have accounts or pledges receivables, or substantial accounts payable. In addition to the cash receipts and cash disbursements journal, an accounts receivable journal and an accounts payable journal are needed. The accrual method should be used to more accurately reflect the true income and expenses of an organization over a period of time.

Some nonprofit organizations find that the natures of their transactions recommend some aspects of the cash and some aspects of the accrual methods of bookkeeping. This is the case for an organization with minimal accounts receivable or accounts payable throughout the year. The hybrid method of bookkeeping that applies in these instances is called the **modified accrual** basis. During the year, the books are kept on the cash basis, using only a cash receipts and cash disbursements journal. At the end of the year, listings of the accounts receivable and account payable are compiled, item-by-item. The total amount of this listing is then brought onto the books by an adjusting entry in the general journal. This will, in effect, convert the cash basis books to an accrual basis as of the end of the year.

The choice of the proper bookkeeping method for any nonprofit organization should be made only after careful study of the nature of the transactions. (For example, are most bills paid by the end of the month, or is notification of revenues to be received shortly followed by actual receipt of the contribution?) It is very important that the organization's basis of bookkeeping produces an accurate picture of the organization's financial positions.

Chart of Accounts

The chart of accounts should be the first focus when establishing a bookkeeping system or reviewing the effectiveness of an organization's existing system. The chart of accounts is the mechanism for categorizing the operations. Each account in the books is assigned a title and number and is classified under a general category or type of account-

assets, liabilities, fund balance revenue and expenses. The title of each individual account should clearly describe the nature of the account; e.g., "Accounts payable", "Grant revenues", "Rent Expense". A numbering system should identify each account and the number should reflect the category or type of account (asset, liability, etc.). The following is a numbering system used by many nonprofit organizations:

Type of account	Account Number
Assets (Cash, Equipment)	100-199
Liabilities (Accounts Payable, Loans)	200-299
Fund Balance (restricted and Unrestricted)	300-399
Revenue (grants, interest Income)	400-499
Expenses (salaries, Rent)	500-599

The sample chart of accounts furnished in Appendix A includes most of the accounts that will be necessary for the average nonprofit organization.

The annual Budget and its categories is a good place to start in determining appropriate account titles for the revenue and the expense accounts. It is most important that the accounts not be too generalized. Each organization must find its own balance between too few accounts (that may not provide sufficient information) and too many categories (that could result in confusion)

Once an effective chart of accounts has been developed, the organization uses these same accounts of revenue and expense for the budget, the bookkeeping system and the internal financial statements. This way, comparisons between budgeted and actual revenue and expenses are meaningful.

Some organizations may be required to report financial information in accordance with a chart of accounts specified by a major funding source. In such a case, it is advisable to work within the constraints of the requirements, formulating budgets and keeping the books on the specified basis.

Journals and Ledgers

The journals and ledgers--"the books"-- are the principal components of a bookkeeping system. The process of "keeping the books" or "bookkeeping" is merely the recording of all financial transactions into the appropriate journals and ledgers.

The nature and form of an organization's books will vary with the needs and complexity of the organization. Many organizations will find that columnar accounting paper will suffice; others need the timesaving benefits of a one-write system. A

computerized bookkeeping system is valuable for complex, decentralized nonprofit organizations with budgets that can accommodate computer services.

Journals are those books in which similar transactions are recorded and efficiently summarized. The key to understanding the operation of a journal is to see that each transaction is recorded twice: once in a "total" column, and again in a specific "category" column.

The category columns in a journal serve two important functions: (1) the columns allow information to be readily summarized by function or type of account; (2) the columns make it possible to maintain balance in the bookkeeping system. Since each transaction is recorded in the total column and at least one other column, the work can be double-checked by determining that the addition of all columnar sums equals the sum of the total column.

All income is recorded in the **cash receipts** journal. As each item is received, income is listed in the total column and also in an appropriate columnar category. Appendix A shows categories should be totaled monthly; and, the sum of the separate columnar totals computed to verify that the total agrees with the total of all the cash receipts for the month.

All expenditures should be made by check, and should be listed in a **cash disbursements** journal. Appendix A illustrates the standard cash disbursements journal format. The columns in the journal should correspond to the budget categories and should be totaled and verified monthly.

The general journal is used to record those transactions, which cannot be put into any other journal. For example: depreciation, amortization, and interest on savings or NOW accounts are recorded in the general journal. Sample journal entries are shown in Appendix A.

The accrual method of accounting requires the use of two additional journals- the **purchases journal** and the **sales journal**.

The **general ledger** summarizes and continually updates all financial information. Each journal is totaled monthly, and these totals are then transferred or "posted" to the general ledger.

Once all journals have been posted to the general ledger, a trial balance can be prepared. A **trial balance** is a listing of each account and its balance in the general ledger. The total debits should equal the total credits, thus verifying the books are balanced.

Bank Reconciliations

One of the most important methods for financial control of an organization is the preparation of monthly bank reconciliations for all bank accounts.

Preparing bank reconciliations involves reviewing the checkbook balance and the general ledger each balances. The reconciliation verifies that these balances agree with (are reconciled with) what the bank states are the cash balances. Reconciliation is the primary method of double-checking the organization's handling of cash receipts and disbursements during the month, and points out any errors. Good internal control procedures dictate that bank reconciliations be done by someone who does not record cash receipts and disbursements.

Most bank statements include a format for preparing a reconciliation, with instructions for its use. An alternative, step-by-step procedure for preparing a bank reconciliation is outlined in Appendix A.

Effective Petty Cash Accounting

A nonprofit organization often needs cash available for various small expenditures. This need can be satisfied by the institution of a petty cash system. The installation of proper accounting controls insures that a petty cash system functions smoothly.

The first step is deciding how large the petty cash fund should be. There may be a need for \$50, \$75, \$100 or more available at any time. The directors should determine an appropriate amount. Petty cash should be kept in a locked box or in an envelope inside a locked drawer, with only one person responsible for keeping and disbursing cash.

Disbursements from the fund should be made only when an authorized receipt is presented. This rule should be made clear to the staff and followed strictly. Since the books and records of the organization are open to examination at any time by the federal government, proper supporting documents should be available to prove the expenditures.

The most common and effective system of recording petty cash expenditures is called the "impress method". At any given time, the total amount of the fund will always be present in the petty cash box, either in the form of cash or in form of receipts. When the fund needs to be replenished, a check is drawn for the total amount of the receipts in the box. The amount of this check is then distributed to the appropriate categories in the cash disbursements journal reflecting the proper account to which the expenditure is to be charged—postage, supplies, travel, etc. All the petty cash expenditures are thus included in the journals and the general ledger.

Functional Reporting (Reporting by Program)

Financial management analysis can be done from the different perspective than is presented here through the process of studying the various programs offered by your organization. The use of functional or programmatic allocation procedures affects every aspect of the financial information system. Therefore, budgets are prepared listing each program's expected revenue and expenses. Cash receipts and disbursements are categorized in the journals by program. And financial statements show the programmatic revenue and expenses.

Functional reporting is required by the American Institute of Certified Public Accountants' Voluntary Health and Welfare Adult Guide for financial Statement Preparation, and by the Pennsylvania Commission on Charitable Organizations' registration forms. It is also recommended method of evaluating program performance.

Funds restricted in use by the donor must be segregated from the general operating funds in the bookkeeping system. A separate general ledger or checking account is sometimes used to do this.

Internal Financial Reporting

The need for Financial Information

Managing the organization's money requires financial information, which is usually presented in a "financial statement". Financial statements provide the board of directors with feedback on the organization's financial position.

Financial statements must be complete and accurate, and must be presented in a timely manner so quick reactions are possible. A board of directors that is provided with timely, complete and accurate financial information can remain in close harmony with the finances, see the results of fundraising, and act quickly on potential problems. It is the responsibility of the treasurer to keep the board well informed by issuing regular (preferable monthly) financial statements.

The Source of Financial Information

The financial information reported to the board should be taken directly from the financial books and records of the organization—the general ledger or its equivalent, or a "trial balance". Financial statements should be easily traceable to the books, should questions arise.

Formats for Presentation

Ideally, internal financial statements should be prepared for each board meeting. At a minimum, statements should be prepared every quarter.

Many organizations find it helpful to present two financial statements at each board meeting: a statement summarizing revenues and expenses of the most recent period; and a year-to-date statement, which summarizes the transactions of all the months in the current year.

Financial statements should detail the sources of revenue and support and the expenditures of these funds and note the cash balances at the beginning and the end of period. They should also compare amounts actually received (or accrued) and actually expended (or accrued) with budgeted amount, noting any variance between budget and actual.

When the statement is prepared on a monthly basis, the annual budget can be divided by twelve. Adjustments, however, may be necessary. For example, if all fundraising is done at one time of the year, then revenues should be allocated only to those months when it is expected to be received. In the same way, if certain expenses will be paid only in particular months, then those expenses should be shown only in that month's report.

Once the month's budgeted amounts are determined, they can be compared with the actual amounts. The year-to-date information can be presented in the same way, clearly showing variances from the budget.

In a financial statement, revenues are listed first, by source (budgeted amount, actual amount, and variance), followed by expenses listed by expense category (budgeted amount, actual amount and variance). The preparer then calculates and shows the "excess or deficiency of revenues over expenses". On the following line, the preparer shows the cash balance at the beginning of the reporting period.

A common (and well-advised) practice is to show the organization's cash balance at the end of the reporting period. This is accomplished by adding the excess to (or, subtracting the deficiency from) the beginning cash balance. This only applies to cash basis reporting, which may not be an accurate reflection of the month's activities.

A sample internal financial report is shown in Appendix B. This example should be used only as a guide. A format useful to the organization should be developed.

Evaluating the Internal Financial Report

The internal financial report provides information that is useful to the organization. It is, therefore, important that the statement be carefully prepared by the responsible party and thoroughly reviewed by the directors.

All variances exceeding a predetermined percentage of the budgeted amount should be investigated and discussed by the board. Small variances can lead to larger budget problems, and continued monitoring allows quick and appropriate reactions.

Internal financial reports should work for the organization. Understanding their preparation and carefully structuring their format allows reports to be furnished efficiently and easily. Analyzing the financial information on a regular basis will enable management to steer the organization.

Cash Flow Management

Cash Flow Planning

Nonprofits are advised to synchronize fundraising and expenditures to avoid a cash shortfall. This coordination between support and expenses is called “cash flow planning”.

A nonprofit organization must pay close attention to the problems of cash flow. Even when an organization estimates that the year’s total funding will be adequate to meet the projected expenses, the timing of the receipt of the revenue is utmost importance.

The first step in cash flow planning is analyzing the organization’s cash needs on a monthly basis. Schedules of projected receipts and disbursements should be prepared – the format shown in Appendix C can be used as a guide. In preparing the projections, keep the following questions in mind:

- During which part of the year is fundraising done?
- When will grants (foundations, government, etc.) be received?
- When will salary increases go into effect?
- When will changes in employee payroll taxes take effect?
- Will rent or other fixed expenses increase during the year?

In projecting receipts and disbursements, use the categories in the organization’s charts of accounts. For each category of receipt, estimate the anticipated amount and timing of its receipt. In each monthly column, enter the amounts expected to be received for the given category. Total all monthly amounts and record the total in the right-side “TOTAL” column. Repeat this process through all categories of receipts and for all categories of disbursements.

When all estimated amounts have been entered on the form, total the receipts and the disbursements for each month. To double-check the totals, be sure the sum of the monthly amounts equals the sum of the category totals.

After the projected receipt and disbursement forms are completed, the monthly totals are entered on a projected cash flow form (Appendix C). Beginning with the first month of the fiscal year, state the cash balance at that time in Column A; in Column B, state the projected receipts for that month; in Column C, state the projected disbursements. The estimated cash balance at the end of the month will result from the simple formula: $A+B+C=D$. The cash balance at the end of the month 1 becomes the beginning cash balance for month #2. This same process is repeated for the entire year.

Using Cash Flow Information

If the balance of cash on hand at the end of any given month (Column D) drops below zero, the organization will experience negative cash flow. Such a condition indicates that receipt of revenues may not be timed to insure a continuity of operations, and the board should take steps to improve the cash flow (by short-term borrowing, cutbacks in program delivery, or increased fundraising efforts.)

Cash flow planning is an exercise designed to assure that adequate cash is available during the year to meet budgeted expenditures. This forecasting is essential to allow the board adequate time to investigate alternative sources of and strategies for raising needed revenue. Proper planning and close monitoring of the cash flow allows a nonprofit organization to sustain uninterrupted delivery of its program

Monitoring Cash Flow

The final step in the cash flow planning process involves analysis of results at the end of the fiscal year. An “Actual Cash Flow” form similar to that shown in Appendix C should be used to provide feedback for future cash planning.

Using this form, the actual cash balances can be compared with the projections, and the resulting variances can be analyzed. Variances may be caused by inaccurate budgeting, problems with fundraising efforts, failure to adhere to the budget, or a combination of these factors. A careful analysis of “what went right” and “what went wrong” in the cash flow planning will provide helpful information for preparing future projections.

Investing Cash

Cash flow planning enables a board of directors to take full advantage of any excess cash balances. When more cash is available at the end of a month than is needed to cover the next month’s expenditures, the “excess” cash can be invested.

The most important factors to be considered in the choice of investment options are risk, yield and the liquidity of funds. Since a nonprofit organization is custodian for money contributed by the general public, the risk should be virtually eliminated in the investment strategy. For many boards this means choosing to invest in government-insured or government-backed securities with no risk of losing the principal.

Investment yields vary with the degree of risk involved and the availability of funds. Savings accounts with banks pay a low interest rate, and the money is available for withdrawal at any time. The bank's savings certificates and money market checking accounts may offer slightly higher rates than a savings account. The certificates can be issued for thirty-month, twelve-month, or six-month periods, or less. Certificates must be held for the full period of time specified to earn the full amount of interest, and there are substantial penalties for early withdrawal.

Obviously, organizations should not "tie-up" funds for any time period unless they are confident the funds will not be needed during that time. The money market checking accounts, however, offer substantially greater access to invested funds. The savings options offered by banks are governmentally insured, up to a maximum of 100,000.00.

Many investment firms and mutual funds offer a fund that is fully invested in government backed securities. The rate of interest is usually a few percentage points higher than a money market fund, but the principal is less secure.

In sum, the excess cash of a nonprofit organization should be used to generate additional revenues in the form of interest earned. Understanding the cash flow needs of the organization will insure optimum use of available resources.

Internal Control

An important element in the effective management of a nonprofit organization is the management control system or "Internal Control".

Internal accounting control is defined as "the plan of organization and all of the coordinated methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies."

Managers are responsible for implementing systematic procedures for providing control in four areas:

1. Authorization of expenditures
2. Recording of financial transactions
3. Access to the organization's assets
4. Accountability for the assets.

The design of an internal accounting control system, approved by the board of directors, varies depending on such things as size, number of employees (especially accounting staff), location of operations, complexity of the organization and management philosophy. Smaller groups are dependent on day-to-day involvement of management to ensure effective control.

An effective internal control system requires the board to:

- Clearly defining the organization's policies and procedures, including job descriptions;
- Effectively communicating these policies to the staff;
- Establishing the adequate number, competence and integrity of employees;
- Segregating duties and responsibilities, particularly those related to the finances;
- Assuring adequate supervision

No internal accounting control system is expected to achieve perfection. These systems are expected, however, to provide reasonable assurance that the broad objectives of authorization, recording, access to assets and asset safeguarding are achieved (see Appendix D).

One of the most important principles of internal accounting is that duties are assigned to several individuals so no one person can control all phases of processing a transaction. Otherwise, errors of omission or commission may go undetected. Ideally, the flow of activities could be designed so the work of one individual is either dependent of – or serves to check – the work for another. For example, duties of depositing receipts and reconciling bank statements should be segregated. If one individual controls both functions, some contributions may be concealed by circumventing usual procedures.

In smaller organizations, management may not have enough people to properly segregate duties for effective internal control. Control objectives may be achieved by having managers who are responsible for authorizing most business transactions supervise day-to-day activities. This way, management can assure adherence to controls by personal observation and inquiry.

In any event, reasonable assurance that internal control is maintained depends on the competence and integrity of employees, the independence of their assigned functions, and their understanding of the prescribed procedures. The overall effectiveness of the system also depends on having an adequate number of competent employees to perform the assigned functions. Neither competent people without a control system nor an elaborate control system without competent people is sufficient. Properly trained people help create the appropriate control environment.

A “weakness” exists in internal control when both of two possible circumstances are present: (1) a procedure is inadequate, thus allowing an error to occur—for example, the check signer does not review and initial underlying documentation when signing checks (inadequate procedures), as a result a check is signed and payment made for goods not received (an error occurs); (2) the system does not detect errors on a timely basis.

To determine how important a weakness is, the “exposure” should be identified and measured. The magnitude of the risk (e.g., the amount of potential loss) should be estimated, and frequency of occurrence measures the exposure. For example, if a given set of circumstances could result in a loss of \$1,000 but the loss might happen only once in ten years, the annual exposure is \$100. If a weakness could allow a loss of \$5 to occur one hundred times a month, the exposure is \$6,000 per year. Of course risk is difficult to quantify and these examples are only meant to illustrate potential loss.

These examples assume that exposure arose from a single weakness. If more than one weakness can affect an aspect of internal control, the aggregate exposure resulting from all known weaknesses should be evaluated. The combined effect of several individually insignificant weaknesses may be serious and require attention.

The other side of internal accounting control—the benefit to be derived—is the reduction in exposure. The benefit comes from reducing the magnitude of risk or the probability of its occurrence. Not all benefits can be expressed monetarily. For example, one of the objectives of internal accounting control—that transactions be recorded when required—assures the preparation of reliable financial statements.

The concept of reasonable assurance recognizes that the cost of internal accounting control should not exceed the expected benefits. As a practical matter, control techniques need to be tempered by considering the volume, complexity and significance of the steps necessary to impose them. Consideration must be given to the burden of implementing controls in relation to the degree of risk, which might arise in their absence.

An organization will benefit from controls as it grows. As transactions become voluminous, management cannot continue to approve every transaction and proper controls become essential.

In general, one thing is certain: management has to manage the organization. Working within the constraints of available resources, it is important for organizations to focus on -- and cure -- the greatest exposures. Next, management should look at the lesser exposures and address those where the cost-to-benefit ration makes it worthwhile. If controls were free or funds were unlimited, an ideal internal accounting control system could be installed. But funds are limited and controls are not free.

A long-term commitment to an internal control system recognizes that the benefits to be realized are not always immediate. For example, controlling a \$10,000 risk

that happens only once every ten years does not have an immediate return. An organization might be willing to spend \$750 a year to avoid that \$10,000 loss, but it is only after the loss occurs that there is a return on the control investment.

The most important lesson, which nonprofit organizations can learn from the business community, is the value of effective internal controls. Just as the corporation has an obligation control over the finances, the nonprofit organization has a stewardship responsibility to control the funds, which have been entrusted to it. Internal controls are essential to the success of every non-profit organization.

In analyzing the extent to which an Organization's internal controls are adequate, we recommend use of the Internal Control Checklist provided in Appendix D.

Federal and State Reporting Requirements

Introduction

Although, for the most part, nonprofit organizations are exempt from paying income taxes, there are some taxes and reporting forms they must file. Executive directors and financial officers of tax-exempt organizations should be aware of any tax filing or other reporting requirements imposed by the federal government and respective state and local governmental agencies. Legally, the continued delivery of program services depends on compliance with governmental rules and regulations, therefore nonprofits must be sure to file all required forms.

Exempt Organizations

There are many types of organizations that are exempt from federal income taxes under the Internal Revenue Code. Organizations exempt under section 501 (c) (3) are the most common. They are usually operated for religious, charitable or educational purposes.

In order to establish its exempt status, an organization must file an application for (either form 1023 for organizations falling under section 501 (c) (3) or form 1024 for all others) with the IRS. The application form requires both financial and operational information and it is often recommended that organizations seek some professional legal and /or financial advice before filing the form.

Federal Forms

Organizations exempt from paying federal income taxes under section 501 (c) of Internal Revenue Code are required to file form 990 annually. The following types of organizations, however, are not required to file an annual Form 990:

- A church, an association of churches, or a church auxiliary

- An exclusively religious activity of any religious order
- An organization which normally does not have more than \$25,000.00 in gross receipts for a year
- A mission society sponsored by or affiliated with a church
- A school which is affiliated with a church and is below college level
- A state institution
- A corporation organized under an Act of Congress
- A stock bonus, pension or profit-sharing plan
- A private foundation. Private foundation are required to file Form 990PF annually

If an organization, which normally does not have annual gross receipts in excess of \$25,000.00, receives a 990 package from the Internal Revenue Services, it should file the form anyway. That organization should attach the preprinted label to page 1 of the form, check the first box in item K, sign and mail the form to the IRS.

Every nonprofit organization that is required to file a Form 990 and is exempt under code sections 501 (c) (3) (except a private foundation), 501 (e) or 501(f) also must complete and submit schedule A (of the form 990). Schedule A requests supplementary information on compensation, activities and the sources of support for the organization.

Both the 990 and 990PF must be filed with the Internal Revenue Service by the 15th day of the 5th month after the end of the organization's fiscal year. For example, an organization with a fiscal year-end of December 31st must file Form 990 by the following May 15th. If the organization's fiscal year-end is June 30th, then the 990 Form is due November 15th.

Any tax-exempt organization which received gross income of \$1,000,000 or more from an unrelated trade or business within its fiscal year must file Form 990T, "Exempt Organization Business Income Tax Return". Form 990T must be file with the Internal Revenue Service by the 15th day of the 5th month after the end of the organization's fiscal year.

Unrelated business income is any income from a business, which is conducted regularly, and not substantially related (other than the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance of the organization's charitable, educational or other purpose constituting the basis for its exemption. Unrelated Business income is subject to federal income taxes at corporate rates. However, the first \$1000 of unrelated business income is exempt from federal income taxes.

In Pennsylvania, all federal forms (990 and related forms) are mailed to the following address:

Internal Revenue Service Center
Philadelphia, Pa 19255

In New Jersey, all federal forms are mailed to:

Internal Revenue Service Center
Holtsville, NY 00501

All federal forms may be obtained by writing or calling:

Forms Distribution Center
P.O. Box 25866
Richmond, VA 23260
(215) 574-9900 or 1-800-Tax-Form

Pennsylvania Forms

In 1971, the Commonwealth of Pennsylvania established a Bureau of Charitable organization (BCO) to safeguard the public solicitation of charitable funds. The BCO requires all nonprofit organizations, which intend to solicit contributions from the public in Pennsylvania to register annually with the Bureau.

An Organization should file Form BCO-400, the "Short Form Registration", if any one of the following conditions is true:

- The group solicits contributions only from its members.
- The group has not solicited and does not intend to solicit from the public more than \$25,000.00 in any year, and no part of the organization's assets or income benefits or is to be paid to any officer or member.
- Contributions are solicited only for the relief of a specified individual and are turned over, without and deductions whatsoever, to the named beneficiary for his/her use.

For BCO purposes, direct contributions are defined as the aggregate amount of Money, pledges or other property raised by reason of any solicitation activities.

All filings are mailed to the State BCO office no later than 135 days after the fiscal year-end of the organization. The forms are mailed to:

Commonwealth of Pennsylvania
Department of State
Bureau of Charitable Organizations
Room 308, North Office Building
Harrisburg, PA 17120

All registration forms must be notarized. The audited or reviewed financial statements must be signed by either a certified public accountant or a registered public accountant. The audit or review must be performed in accordance with standards established by the American Institute of Certified Public Accountants. All registrations must be accompanied by a fee, payable at the time of filing. The fee schedule is:

To request forms or additional information, the commissions of Charitable Organizations may be contacted at the address noted or by calling (717) 783- 1720.

Payroll Tax Obligations

Once an organization hires employees, the tax and information requirements increase dramatically. This section is designed to give the agency an idea of the types of consideration that comes with the addition of employees.

Every employer is required to get an employer's identification number (EIN). The form used to apply for an EIN is an SS-4 form and can be obtained from the Internal revenue Service. In addition, a Pennsylvania employer is required to register with the state and Philadelphia employers with the city. The agency should call the local divisions of taxation and tell them that the agency is a new employer. The appropriate forms will be mailed to the agency and they should be filled out and returned immediately. These registration forms cause the agency to be added to the mailing list.

Each employee must complete a W-4 form (Withholding Allowance Certificate) before he/she begins work. This form indicates to the employer the rate at which the employee should be taxed.

Once these preliminary forms and registration have been filed, The employer needs to become familiar with the various federal, State and Local filing requirements. See Community Accountants' *Tax and Reporting Guide for Nonprofits and Small Businesses* for details.

Bookkeeping Basics

Sample Chart of Accounts

<u>ACCOUNT #</u>	<u>DESCRIPTION</u>
Assets	
101	Petty Cash
102	Cash- General Checking
103	Cash- Savings
104	Cash- Restricted Funds
110	Accounts Receivable
120	Prepaid Expenses
130	Van & Transportation Equip.
131	Equipment
140	Accumulated Depreciation –Van
141	Accumulated Depreciation- Equip.
Liabilities	
201	Accounts payable
210	Federal Withholding Payable
211	FICA Payable
212	PA Income Tax Payable
213	City Wage Tax Payable
220	Accrued Salaries
290	Loans Payable
Fund Balance	
301	Fund Balance- Unrestricted
302	Fund Balance- Restricted
Income	
401	Foundation Grants- Unrestricted
402	Foundation Grants- Restricted
410	Governmental Contracts
420	Client Fees
430	Corporate Contributions
440	Interest Contributions
490	Interest Income
499	Miscellaneous Income
450	Membership Fees

Expenses

501	Payroll
502	Employer's FICA tax
503	State Unemployment Tax
504	Fringe Benefits
505	Workmen's Compensation Insur.
510	Rent
511	Utilities
512	Use & Occupancy Tax
520	Property Insurance
521	Liability Insurance
530	Telephone
531	Postage
532	Office supplies
533	Repairs & Maintenance
534	Office equipment Rental
535	Computer Costs
540	National dues
541	Dues and Subscriptions
550	Volunteer Expenses
560	Van Gas & Maintenance
561	Van Insurance
570	Consultant Fees
571	Legal Fees
572	Audit & Accounting Fees
580	Fundraising Costs
590	Interest expense
595	Depreciation
599	Miscellaneous Expenses
601	Payroll- Restricted
602	Employer's FICA Tax- Restricted
603	State Unemployment Tax-Restricted
604	Fringe Benefits- Unrestricted
605	Workmen's Compensation Insurance- Restricted
610	Rent- Restricted
611	Utilities- Restricted
612	Use & Occupancy Tax-Restricted
630	Telephone-Restricted
631	Postage- Restricted
632	Office Supplies- Restricted
695	Depreciation- Restricted
699	Miscellaneous Expense- Restricted

Sample General Journal Entries
For the Month of June

Date	Description	Debit	Credit		
6/30	Depreciation Expense				
	Accumulated Depreciation				
	To record depreciation expense For the month of June (1/2 of the total annual budgeted amount				
6/30	Insurance Expense				
	Prepaid Insurance				
	To expense 1/2 of the total insurance paid as June's exp.				
6/30	Telephone Expense				
	Office Supplies				
	To correct an error in May's cash disbursements journal in which check # to Bell of PA was incorrectly posted to office supplies Expense				
6/30	Cash- Savings Account				
	Interest Income				
	To record interest income for the month of June as shown on savings account Statement				

Internal Financial Reporting

Bank Reconciliation Procedures

1. Check off each item returned by the bank with the corresponding amount shown on the bank statement.
2. Check the deposits listed on the bank statement with the prior month's bank reconciliation to determine that deposits, which were in transit last month, appear on the current month's statement. Place a check mark beside each deposit that was compared.
3. Compare the remaining deposits on the bank statement with the cash receipts journal, noting the date and amount of each deposit. Place a check mark beside each deposit that was compared.
4. Adjust the cash receipts journal for any credit memos which appear on the bank statement and are not listed in the cash receipts journal
5. List those deposits which were made but do not appear on this month's bank statement on the bank reconciliation form. These are the deposits in transit.
6. Put the checks in numerical order.
7. Compare the checks returned in the current month's bank statement with those checks, which were listed, as outstanding on last month's bank reconciliation and place a check mark beside those checks, which have been compared. Look closely at the date, the check number, amount, payee, signature and the endorsement on the check.
8. Compare the remaining checks with the current month's cash disbursements journal, and put a check mark next to those checks, which have been compared. Look closely at the date, check number, amount, payee, signature and the endorsement on the check.
9. Adjust the cash disbursements journal for those charges shown on the bank statement, which are not listed, on the cash disbursements journal. This would include bank charges, returned checks or debit memos.
10. Look at the prior month's outstanding checklist and the current month's cash disbursements journal and list on the bank reconciliation statement those checks, which have not been checked off. These are the checks, which have not yet cleared the bank, or the outstanding checks.
11. Add the bank balance to the deposits in transit, and record this amount on the "subtotal" line. Then add all of the outstanding checks and show this amount on the "total outstanding" line. Subtract the total outstanding checks from the subtotal, and record this amount as the cash balance at the end of the month.
12. Record the cash balance as shown in the checkbook, and list any items, which appear on the bank statement but not in the checkbook as reconciling items. The total cash balance should agree with the cash balance obtained in step #11.
13. Record the cash balance as shown in the general ledger, and list any items, which appear on the bank statement but not in the general ledger as reconciling items. The total cash balance should then agree with the cash balance obtained in step #11.

Sample Bank Reconciliation
For the month of June

		Balance per bank Statement @6/30			
		Plus: Deposits in Transit			
		Subtotal			
		Less: Outstanding Checks			
		Total Outstanding			
		Other Reconciling Items:			
		Cash Balance @ 6/30			
		Balance per Checkbook @ 6/30			
		Reconciling Items:			
		Cash Balance @ 6/30			
		Balance per General ledger @ 6/30			
		Reconciling Items:			
		Cash Balance @6/30			

Treasurer's Report- Cash Basis
For June

		DEBIT	CREDIT	BALANCE	
	Cash Receipts				
	Grants				
	Corporate Contributions				
	Other Contributions				
	Client Fees				
	Interest Income				
	Other Income				
	Total Receipts				
	Cash disbursements				
	Payroll				
	Payroll Taxes/ Fringe benefits				
	Rent				
	Utilities				
	Telephone				
	Postage				
	Office Supplies				
	Professional Fees				
	Insurance				
	Total disbursements				
	Excess Receipts				
	Balance 5/31				
	Balance June 30				S

Projected Cash Flow

	(A)	(B)	(C)	(D)
MONTH	Cash-Beginning Of month	Projected Receipts	Projected Disbursements	Cash- End of Month

Actual Cash Flow

	(A)	(B)	(C)	(D)
MONTH	Cash-Beginning Of month	Projected Receipts	Projected Disbursements	Cash- End of Month

Internal Control Checklist

General	Yes	No	N/A
1. Are there documental procedures for gathering financial information and recording transactions?			
2. Is there adequate bonding of employees involved in recordkeeping and custody of assets?			
3. Does a qualified supervisor review the work of the bookkeeping on a regular basis?			
4. Is a meaningful chart of accounts in use?			
5. Are all bills paid by checks?			
6. Are the journals and the general ledger kept up to date and balanced monthly?			
7. Are there support documents available for each transaction recorded In the agency's books?			
8. Are bank reconciliations prepared monthly?			
9. Is a trial balance prepared monthly?			
10 a. Has the organization ascertained the indirect costs associated with operating each of its separate programs or departments?			
b. Are cost allocations made functionally, e.g., among programs?			
c. Are these allocations based on reasonable and documented assumptions?			
d. Are they reviewed for accuracy periodically?			
11. Have all relevant federal, state, and local tax forms been filed on time?			
12. Has the Board filed updated bank resolutions, with the correctly designated check-signators?			

Cash Receipts	Yes	No	N/A
1. Are cash receipts deposited intact and on a timely basis?			
2. Are receipted deposit slips compared with the cash receipts journal by someone independent of the bookkeeping function?			
3. Is a listing of daily mail receipts prepared by someone other than the bookkeeper when feasible?			
4. Are all daily receipts reviewed by the appropriate level of management?			
5. Do cash receipts procedures include safeguards to assure that all funds due are ultimately collected and credited to the appropriate clients' accounts?			
Cash Disbursements			
1. Are cash disbursements made by pre-numbered checks?			
2. Are voided checks retained and accounted for?			
3. Are those persons who are authorized to approve expenditures clearly designated?			
4. Are all expenditures approved by an authorized person?			
5. Are two signatures required on each check?			
6. Do agency procedures assure that checks are never signed in advance?			
7. Is the supply of unused checks adequately safeguarded?			
8. Are requests for expense reimbursement accompanied by appropriate receipts and/or approval of authorized person?			
9. Are Bank reconciliations reviewed by management?			
10. Are the duties of writing checks and reconciling the bank statements Segregated?			

Accounts (Pledges) Receivable	Yes	No	n/a
1. Are monthly billings mailed to clients with receivable balances?			
2. Are individual account balances reconciled with the general ledger account on a monthly basis?			
3. Is an aged listing of accounts receivable prepared monthly and reviewed by management?			
4. Are procedures in effect for handling delinquent account balances?			
5. Are disputed accounts reviewed by management?			
Purchases and Accounts Payable			
1. Are all approved invoices promptly recorded in a voucher register and amounts distributed based on a meaningful chart of accounts?			
2. Are all unpaid invoices kept in a separate file and scheduled for payment?			
3. Are statements from vendors compared with open invoices?			
4. Is an aged listing of accounts payable prepared monthly and reviewed by management?			
5. Is the mathematical accuracy of vendors' invoices verified?			
6. Does the organization take advantage of discounts in paying bills?			
7. Is the authorized signature required to confirm the receipt of goods before an invoice is paid?			
8. Are all original invoices and support marked paid to avoid any duplicate payments?			

Petty Cash	Yes	No	n/a
1. Is only one person responsible for the petty cash fund?			
2. Is each withdrawal from the fund supported by a voucher?			
3. Are receipts attached to the voucher?			
4. Is the fund periodically counted by someone other than the keeper of the funds?			
5. Are the vouchers reviewed periodically by someone other than the keeper of the funds?			
6. Is the fund kept on an imprest basis?			
7. Are vouchers filled out-in ink, dated, and approved by a designated Signator?			
Payroll Procedures			
1. Is there written authorization from the board to the Executive Director for each addition to the payroll or change in employee payroll status?			
2. Is this information supplied to the accounting manager?			
3. Are time sheets or sign-in sheets required for all employees?			
4. Are time sheets or sign-in sheets approved by the responsible Supervisor?			
5. Is there a payroll card or other summary of each employee's pay kept on a year-to-date basis?			
6. Are totals of employee payroll cards compared on a regular basis with periodic payroll summaries and subsequently compared to the general ledger?			
7. Are current withholding authorization forms required for all Employees?			

Fixed Assets	Yes	No	n/a
1. Are all fixed assets listed in a fixed asset ledger including the complete purchase or donation value?			
2. Are there adequate controls for the safeguarding of fixed assets?			
3. Are all fixed assets periodically inventoried to verify their existence?			
4. Is the legal title of ownership for all agency assets maintained on file and properly safeguarded?			